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SEPTEMBER 16TH–22ND 2006 www.economist.com

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The balance of economic power in the world is changing. A welcome development: leader

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Politics this week

Sep 14th 2006
From The Economist print edition

AP

America commemorated the fifth anniversary of the terrorist strikes of **September 11th** 2001. In a series of solemn events, George Bush went to Ground Zero in New York, the Pentagon in Washington, DC, and Shanksville, Pennsylvania, to honour the almost 3,000 victims of the attacks.

In a nationally televised broadcast, Mr Bush once again made the link between September 11th and the war in Iraq. Democrats rejected it, and a long-awaited Senate report on **pre-war intelligence** disclosed the CIA's conclusion of no links between al-Qaeda and Saddam Hussein.

In a closely watched race, Lincoln Chafee, a moderate Republican senator who has often opposed the party line, won his primary election in **Rhode Island**. Mr Chafee faced a strong challenge from the right, but the national party pulled out all the stops to help him win, conceding it would forfeit the seat in November if he lost. See article

Keith Ellison beat the competition to become the Democratic candidate for the congressional district that includes **Minneapolis**. If he wins, as expected, in the mid-term elections, Mr Ellison will become the first Muslim to sit in Congress.

Adrian Fenty won the Democratic primary for mayor of **Washington, DC,** virtually ensuring that he will be elected to the post in November. Anthony Williams, the incumbent, has served the maximum of two terms. See article

One man's freedom fighter

A bomb blast in Diyarbakir, in the Kurdish south-eastern region of **Turkey**, killed 11 people. Turkey has experienced an upsurge of violence by separatist Kurdish guerrilla groups recently.

The deputy chairman of **Russia's** central bank, Andrei Kozlov, was shot dead in the grounds of a leading Moscow football club by two gunmen. Mr Kozlov had been revoking licences for banks suspected of involvement in money laundering.

After infighting last week, senior figures in Britain's Labour Party attempted to dampen further speculation about the date of **Tony Blair's** eventual departure from office. The plea seemed to work. Meanwhile, following his confirmation that he would be gone within a year, Mr Blair made his last visit to the annual gathering of Britain's trade unions. His speech was received with even less grace than usual. See article

The coalition led by Milo Djukanovic, prime minister of **Montenegro**, easily won the first election held since the country became independent in May. Mr Djukanovic is hoping to restart talks on joining the European Union.

Reinforcing Afghanistan

AP

A meeting of NATO at Mons, in Belgium, failed to produce offers of fresh troops to reinforce the security force in **Afghanistan**. Condoleezza Rice, America's secretary of state, had given warning that Afghanistan risked becoming a dangerous failed state, a markedly more downbeat assessment than before. Poland later offered to send 1,000 extra troops to Afghanistan, but not until

February.

Police in **India** said they were exploring the possibility of a link between last week's bomb attacks in the western town of Malegaon, which killed 32 people, and July's bombings in Mumbai. The latest attacks came before this week's expected meeting in Havana, Cuba, between India's prime minister, Manmohan Singh, and Pakistan's president, Pervez Musharraf. See article

China announced a new, more restrictive system of controls on the reporting of court cases. Leaks from anyone other than authorised spokesmen will be punished.

The echo of a dirty war

Ubiratan Guimarães, **Brazil's** former chief of police, who was held responsible for the deaths of 111 prisoners in a riot in a São Paulo jail in 1992, was found shot dead at his home. Although the target of frequent death threats, police believe his murder to have been a crime of passion. See article

An American court ruled that Luis Posada Carriles, a Cuban former CIA agent, should be released from an immigration centre. He is wanted by **Cuba** and **Venezuela** in connection with the 1976 bombing of a Cuban plane that killed 73 people and a plot to kill Fidel Castro. The Americans refuse to deport him, believing he could be tortured.

Making up

Hamas, which runs the **Palestinian Authority**, and Fatah, which used to, agreed to form a national unity government. Ismail Haniyeh, a Hamas leader, is expected to stay on as prime minister. Mahmoud Abbas, the Palestinian president, will be in charge of negotiations with Israel. It remains unclear whether Western countries will resume aid to the PA. See article

A car-bomb attack on the American embassy in **Damascus** was thwarted by local security forces. Three of the attackers and one Syrian security man were killed.

Violence in **Iraq** continued undiminished. The bodies of 60 people were found on one day in Baghdad bound, tortured and shot; car bombs claimed yet more victims. A health ministry report says that 1,536 people were violently killed in Baghdad in August.

Tony Blair went to **Lebanon** for talks with his Lebanese counterpart, Fouad Siniora, about aid for the country. Leading Shia politicians accused him of supporting Israel during its recent conflict with Hizbullah and some 2,000 pro-Hizbullah protesters took to the streets of Beirut.

Experts from the World Health Organisation flew to **Côte d'Ivoire** after deadly toxic waste was dumped last month in residential areas of Abidjan, the country's biggest city. At least six people have died from the pollution and some 10,000 have suffered illness. A public backlash forced the government to resign last week. See article

Unions called a day of protest in **Zimbabwe**, complaining about miserable living conditions, a lack of AIDS treatment for the poor and the fast-collapsing economy. Police detained union leaders before they could march and chased away protesters.

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The African Union approved a plan for the deployment of 8,000 peacekeepers to **Somalia.** The deployment is supposed to take place within weeks, but member countries have yet to stump up the soldiers and money required for the mission.

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Business this week

Sep 14th 2006
From The Economist print edition

In an effort to take some of the heat out of a boardroom spying scandal at **Hewlett-Packard**, Patricia Dunn announced she would step down as chairman in January (in favour of the company's chief executive Mark Hurd). Ms Dunn, who will remain on the board, has been criticised for her handling of the affair, which revolves around the dubious methods used by outside investigators in uncovering the source of a series of boardroom leaks. California's attorney-general said he now has enough information to bring charges in the case. See article

Dell revealed that the Justice Department has joined a widening investigation into the company's accounting. Michael Dell, the computer-maker's chairman, threw his support behind Kevin Rollins, the chief executive.

It emerged that a Russian state-owned bank has taken a 5% stake in **EADS**, making it the biggest investor in Airbus's parent company outside its “core” group of shareholders. It is thought the holding was bought on behalf of a state company set up to co-ordinate strategy in Russia's aerospace industry. An aide to President Vladimir Putin fuelled speculation about how deep a partnership Russia is seeking with EADS by implying that the bank might raise its holding to acquire a blocking stake.

Meanwhile, Mike Turner, the chief executive of **BAE Systems**, which is selling its 20% stake in Airbus to EADS, said he would be “surprised” if there were no more delays to the A-380 super-jumbo. Airbus is assessing the project after a series of hold-ups.

Outside advice for the board

Bristol-Myers Squibb dismissed both its chief executive and general counsel for their conduct in negotiations with Apotex, a Canadian maker of generic drugs, in a patent lawsuit. The decision to sack the pair was made on the recommendation of a federal judge who is monitoring corporate governance at Bristol-Myers as part of a deferred prosecution deal, struck with investigators last year, over a separate accounting scandal.

The **Internal Revenue Service** settled the largest-ever tax dispute in its history. America's taxman reached an agreement with **GlaxoSmithKline**, a British drugs company, in which it will pay $3.4 billion to resolve charges that it tried to minimise its tax bill by underreporting its American profits through a system of transfer pricing. GSK will also drop its claim that it is owed $1.8 billion by the IRS.

Still golden

Two big Wall Street banks cheered investors by reporting better-than-expected quarterly earnings. **Goldman Sachs** recorded a net profit of $1.6 billion for the three months ending August 25th, down slightly from a year ago (and reversing a trend of stellar increases in earnings), but the bank beat estimates thanks to its investment-banking operations. **Lehman Brothers** said its net income for the quarter ending August 31st had risen by 4% to $916m.

Nationwide agreed to take over **Portman**, the biggest merger yet among Britain's mutually owned building societies, creating the country's second-largest mortgage lender after HBOS.

Gold Fields struck a $2.5 billion deal to take control of the South Deep mine near Johannesburg, one of the world's biggest and deepest gold mines. The South African miner's gold reserves will increase by half as a result, taking it closer in size to rivals such as Newmont Mining.

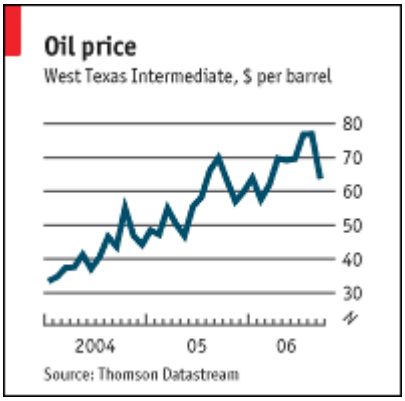
Telecom Italia caused a political storm when it unveiled a plan to spin off its fixed-line and mobile arms in two separate enterprises, hinting that both are up for sale. TI completed the merger of its mobile-phone unit only last year, but now wants to direct its attention to broadband and media services. Any potential sale would help reduce the company's *euro*41 billion ($52 billion) debt, which almost exceeds its market value. See article

Apple Computer unveiled its latest service, films which can be downloaded from its iTunes website. Only Disney titles are available. **Amazon** introduced a similar service last week, Unbox, which offers films from seven Hollywood studios. See article

News Corporation agreed to buy 51% of **Jamba**, which specialises in ringtones for mobile phones, for $188m. The deal gives Rupert Murdoch control of a firm that last year recorded sales of $500m, having unleashed the “Crazy Frog” ringtone on the world.

Good time to fill the tank

The **price of oil** continued to retreat from recent highs, falling to the level it reached in early spring. One factor that affected trading was OPEC's decision not to lower its production quotas (for the time being). However, the head of the IMF warned that oil prices would remain high by comparison with recent years. See article



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The world economy

Surprise!

Sep 14th 2006
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The balance of economic power in the world is changing. Good

IF ECONOMISTS have a tendency to trust their figures too much, politicians often pay numbers too little attention; and they do so at their peril. Napoleon dismissed Britain as a nation of shopkeepers, but its emerging might as a trading power helped fight him off. In the cold war Western strategists probably spent too much time worrying about the Soviet Union's military clout, and not enough analysing its commercial frailties. Economics does not determine history, but it does provide the backbeat. And something dramatic has been happening to the numbers recently.

As our survey this week points out, the emerging world now accounts for over half of global economic output, measured in purchasing-power parity (which allows for lower prices in poorer countries). Many economists prefer to measure GDP using current exchange rates (which put the emerging world's proportion closer to 30%). But even on this basis the newcomers accounted for well over half of the growth in global output last year. And a barrage of statistics shows economic power shifting away from the “developed” economies (basically North America, western Europe, Japan and Australasia) towards emerging ones, especially in Asia. Developing countries chew up over half of the world's energy and hold most of its foreign-exchange reserves. Their share of exports has jumped from 20% in 1970 to 43% today. And, although Africa still lags behind, the growth is fairly broadly spread: they may be the most talked about, yet Brazil, Russia, India and China account for only two-fifths of emerging-world output.

No social or economic change this big takes place without friction. The most obvious sign is the uproar about jobs being “outsourced” to India and China. The howls will get louder as globalisation affects ever-richer voters. But there are wider ramifications too. In Asia China's rise has helped push Japan and India closer to the United States, and South Korea further away from it. The once-poor world is scouring the earth for mineral rights, trying to buy Californian oil firms, accounting for ever more carbon emissions and making its weight felt in international negotiations on everything from trade to proliferation to the secretary-generalship of the United Nations.

An idea whose time has come, again

There are weaknesses in some of the growth stories. China's population is ageing and India's schools are rotten. Perhaps the emerging world won't continue to motor along at nearly three times the rich world's pace. Maybe it will take a little longer than 2040 to fulfil Goldman Sachs's prediction that the world's ten biggest economies, using market exchange rates, will include Brazil, Russia, Mexico, India and China. But

these are arguments about when, not whether, change will happen. And things could speed up: even the rosiest predictions underestimated Asia's ability to recover from its 1997 financial crisis.

This shift is not as extraordinary as it first seems. A historical perspective shows it to be the restoration of the old order. After all, China and India were the world's biggest economies until the mid-19th century, when technology and a spirit of freedom enabled the West to leap ahead. Nor should it be regarded as frightening. The West, as well as hundreds of millions of people in developing countries, has benefited from emerging-world growth. Globalisation is not a zero-sum game: Mexicans, Koreans and Poles are not growing at the expense of Americans, Japanese and Germans. Developing countries already buy half the combined exports of America, Japan and the euro area. As they get richer they will buy more. The world is on course for its fastest-ever decade of growth in GDP per head, which has been powering ahead at an annual rate of 3.2% since 2000—far faster than during the great period of globalisation that ended with the first world war.

Somme where, over the rainbow

If that comparison raises spectres, so it should. A century ago Edwardian globalists were predicting ever more peace and prosperity—only to see those dreams blown apart on the fields of Flanders. The momentum behind globalisation is considerable; but pushing trade barriers lower depends on political will. It is doubtful that any American president would follow the example of the Chinese emperor Qianlong, who announced in 1793 that the then economic superpower had no interest in “foreign manufactures”, setting his country on the road to two centuries of impoverishment. But there are a few worrying omens in the air, notably the collapse of the Doha round of trade talks.

Protectionism and xenophobia should be fought wherever they spring up. But it is also worth acknowledging that these bumptious new economic powers have made the world more complicated for Western policymakers. For instance, although they have helped keep inflation and interest rates down, they have also encouraged asset prices to bubble up. They have allowed America to finance its massive current-account deficit with apparent impunity. Righting these imbalances will be tricky, even if the strength of emerging economies makes the world less dependent on America.

But the two main challenges for the West are long-term political ones. One has to do with accepting that there will be some Western victims of globalisation. Adding 1.5 billion people to the global labour force has boosted the return to capital and richly rewarded rich Westerners; but in Germany, Japan and the United States, real wages for the median worker have barely budged. None of this is an excuse for protectionism—unless you want to make everybody poorer. But there may be fiercer debates, even in America, about using the tax and benefits system to redistribute more of the winnings.

The other challenge has to do with geopolitics. As the balance of economic power in the world changes, mustn't the balance of political power change too?

In time, perhaps. But economic power is not the same as political power. Most developing countries are still military pipsqueaks: China does not yet own a single aircraft-carrier, and its defence budget is less than the annual increase in America's. Nor in political terms is there such a thing as an “emerging block”: no alliance of interests brings all these very different countries together in the way that history and culture have united America and Europe. In Asia, for example, the rise of China is balanced by the rise of India, which America is striving to turn into a strategic partner. But there is also plainly a need to fiddle with some of the global political architecture. The IMF will tinker with the power structure of the fund at its annual meeting next week. Others should follow. The UN Security Council—whose permanent members include Britain and France but exclude Japan, India and Brazil—has long looked outdated and will soon look absurd. Similarly, it does not make much sense for the G7, supposedly the world's main economic club, to discuss currencies when China, which holds the largest official reserves, is not a member.

Making such adjustments will no doubt be awkward. But these are the problems of success. A world in which most people enjoy prosperity and opportunity is surely better than one in which 80% are mired in economic stagnation. Celebrate the riches that globalisation has brought—and be prepared to defend the economic liberalisation that underpins it.

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Japan

The Koizumi restoration

Sep 14th 2006
From The Economist print edition

Japan's remarkable prime minister is about to stand down. Will his revolution last?

AP

Get article background

IT HAS been a thrilling show, but now it is over. On September 20th Japan's Liberal Democratic Party will elect a new leader to replace Junichiro Koizumi, who will formally stand down as prime minister at the end of the month. He is leaving, undefeated at the polls and still popular after five and a half years in the job, only because of term limits imposed by his own party's constitution. But in that brief time he has done more to "change the LDP, change Japan", to quote his best slogan, than any politician of his generation.

Mr Koizumi's achievement is threefold (see article). First, he has changed the way politics is carried out in a country that used in effect to be a secretive one-party state, whose leaders emerged from obscure battles between factions convening in smoke- and *sake*-filled rooms far away from voters' eyes. Mr Koizumi, a rank underdog, snatched the leadership in 2001 only after a huge popular vote from party members forced the hands of the party bosses. He went on to win four elections by appealing, in a way that no Japanese politician had ever even attempted, directly to the electorate. His shaggy hair and natural charisma were refreshing in a party best known for conformity. Most startling of all for Japan, he favoured making big economic reforms.

Those reforms, the second component of his achievement, have probably been a disappointment to him. Stubbornly resisted by his own party, they have been delayed and partial—most notoriously in the case of the privatisation of Japan's postal savings system, which has too often been a way for politicians to direct citizens' savings to favoured contractors. But at least Mr Koizumi began the work of breaking up the "iron triangle"—big business, bureaucracy, LDP—making government a bit more accountable, reining in profligate and inefficient spending and in the process starting to tackle Japan's mountainous public-sector debt.

Partially successful, too, has been Mr Koizumi's quest to let Japan start to play the part it deserves in foreign affairs, his third claim to a place in history. He sent peacekeepers to Iraq, the boldest venture by Japanese troops for half a century, and has worked hard with America to make Japan depend less on America's military umbrella and shoulder more of the burden of its own defence. But he has not succeeded at what ought to have been his priority: the rewriting of Japan's constitution, which renounces

war, to assert Japan's right to participate in collective security. At present Japan's peacekeepers are highly constrained, and cannot legally use their firepower to help defend foreign civilians or assist their allies.

A qualified record then, but the point of Mr Koizumi's stint in office is that he has for the first time challenged the comfortable assumptions that have governed Japan since the war. He has attacked entrenched power: of the LDP's own party bosses, of the bureaucrats, and of the victors of 1945, who imposed pacifism on Japan. The big question, however, is whether any of this has changed for good. Perhaps Mr Koizumi is just a latter-day version of the Meiji emperor who, in the late 1860s, wrested power from the shoguns (feudal lords who had usurped it) and set Japan on the path of modernisation. The “Meiji restoration” did not last long: a new band of oligarchs and militarists swiftly gathered real power back.

In the case of China, proceed with caution

Mr Koizumi's successor, it now seems certain, will be Shinzo Abe, currently Japan's chief cabinet secretary. Like Mr Koizumi before him, he is more or less untested and, at 51, relatively young. But he shows little sign of being an iconoclast. Though Mr Abe is a protégé of Mr Koizumi's, and is generally numbered in the reformist camp, he has not been one of its truly courageous battlers. Nor does he have much of Mr Koizumi's charisma. The danger therefore exists that he will be able neither to enthuse Japan's voters in the way Mr Koizumi did, nor use personal popularity to force his still-reluctant party further down the road of reform.

One area where Mr Abe's reforming zeal may exceed Mr Koizumi's is in international relations. He has already committed himself to rewriting the constitution. But the trick is to do this without sending Japan's relations with China into a tailspin. Japan and China are each other's biggest trading partners, and under Mr Koizumi relations have been bad—in part because of Mr Koizumi's provocative habit of visiting the controversial Yasukuni shrine, and in part because China detests Japan's ambition to play a bigger role. Mr Abe is a hawk who entertains dark suspicions about China. He has also been a regular visitor to Yasukuni. If he stays away from the shrine and makes an early fence-mending mission to China, he could do much for Japan's standing in the world. If not, he risks squandering the legacy of a remarkable prime minister.

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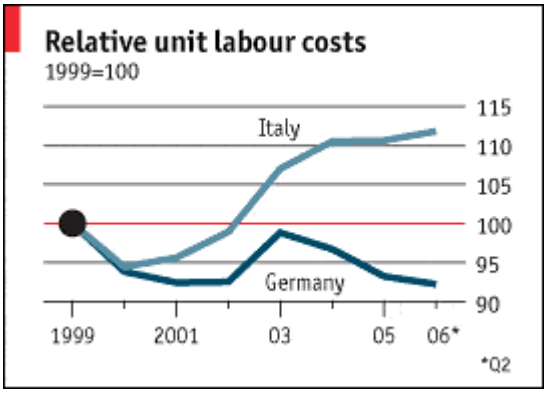
Silvio Berlusconi's bequest

The soft underbelly

Sep 14th 2006
From The Economist print edition

If Italy fails to get its economy in order, its membership of the euro could be at risk



ADVOCATES of Europe's single currency have long played up its contribution to economic reform. Monetary union was always going to be hard for the sclerotic economies of Europe, with their gummed-up labour and product markets. But it was hoped that, by increasing price transparency and cross-border trade, the euro would force reluctant governments to ungum those markets, boosting growth.

Seven years on, this hope has proved largely forlorn. The euro has, indeed, boosted trade. Growth in the euro area has been patchy, though it has picked up sharply this year. There have even been some economic reforms. But in the three core countries of France, Germany and Italy, they have been slow and fitful at best. And hostility to further reform has grown—witness the French government's failed attempt to bring in a more flexible labour contract for youths earlier this year.

The biggest threat to the euro was bound to be Italy. Its public finances were in the worst shape, its productivity growth the slowest, its industries the most exposed to competition from China. Worse, its past cure for these ills was frequent devaluation of the lira. Yet the 2001-06 centre-right government of Silvio Berlusconi proved to be the laggard in Europe. Mr Berlusconi's bequest to Romano Prodi, now the centre-left prime minister, was the slowest-growing big economy in Europe, a continuing loss of competitiveness, a large budget deficit and a public debt that is once again rising as a share of GDP.

Given this inheritance, Mr Prodi has made a promising start. Growth has revived a tad (though Italy remains the backmarker in Europe) and the government has begun to liberalise cosseted service industries. But he now faces sterner tests. The communists and ex-communists in his coalition insist on rolling back the (limited) labour-market reforms introduced by Mr Berlusconi. The squabbling over the budget for 2007 suggests that the task of setting Italy's public finances straight will be Herculean. And the government may yet retreat on plans to trim pensions and health spending (see article).

If only we had kept the lira

The difficulty is not only that economic reform and budget cuts are running into resistance, but also that time is running short. Interest rates are rising, and the world economy's strong growth may not last. Because wages are going up even though productivity is static, Italy's competitiveness continues to deteriorate, especially against Germany's. Some investors may wonder if Italy can ever be rescued so long as it is trapped in the euro. Rating agencies have given warning that they could downgrade Italy's debt again. The Centre for European Reform, a pro-European think-tank based in London, is soon to publish a report which concludes that “if Italy fails to improve its competitiveness, it could be forced to leave the euro zone.”

Financial markets do not yet treat expulsion as a serious possibility. But the longer that Italy's loss of competitiveness and public-finance mess continue, the greater the risk that its euro membership will come into question. There is a sad irony here. Had Italy kept the lira, it would by now have experienced a crisis of confidence and a currency crash that would surely have forced change, just as it did in the early 1990s. But because it is in the euro, no such crisis has arisen. In effect, the euro has made deep reform in Italy simultaneously more economically urgent but less politically pressing. It is a hard time to be the

Italian prime minister.

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Corporate governance

Spying and leaking are wrong

Sep 14th 2006
From The Economist print edition

But there are other, less obvious, lessons from the boardroom farce at Hewlett-Packard

Getty Images

TWO weeks ago Hewlett-Packard was basking in the glory of a remarkable revival. The computer-maker's share price was soaring. Meanwhile, sales were stagnating and batteries burning at its arch-rival, and oft-predicted nemesis, Dell. Now HP is making headlines for all the wrong reasons. An internal inquiry into a leak of confidential information by a director pried into directors' (and journalists') telephone calls, using methods that were at best unethical and possibly illegal. Federal and California state officials are looking into the matter; criminal prosecutions may follow. On September 12th, after long board discussions, the leaky director quit and Patricia Dunn, who had ordered the inquiry into her directors, agreed to step down as HP's chairman (see article).

The first cautionary lesson from these unseemly goings-on is that America's corporate-governance mess is still, alas, unresolved. HP is not just any company, but a famously “decent” place that had won high marks from many of the shareholder activists and politicians who supported the reforms that followed the Enron scandal. These were designed to dismantle the clubby boardroom culture in which directors did the chief executive's bidding. In its place would spring up honest boards in which the chief executive would be accountable to the directors, acting on behalf of a firm's shareholders.

No one could describe the atmosphere on HP's board as clubby. Ms Dunn has long taken seriously the need to hold the chief executive to account, not least by causing the departure of the firm's previous boss, Carly Fiorina. (The willingness to fire the chief executive has come to be seen as the totem of an effective board: witness this week's criticism of the directors of Bristol-Myers Squibb, a drugmaker, for only belatedly getting rid of the bungling Peter Dolan—see article.) Even HP's clumsy attempt to identify the leaky director was arguably part of the effort to raise standards. When a director chooses to leak sensitive strategic information to the press, something is clearly amiss. Ms Dunn's desire to punish such disloyalty was not wrong—it was in the interest of HP's shareholders.

The hyphen in HP

The trouble is that, as the unhappiness at HP makes clear, the alternative to clubbishness is not some genteel exchange of views called “accountability”, but often strife and division. The boardroom has been

an arena where power is contested ever since the first top-hatted directors sat around the first burled oak table. But the duties being heaped on America's boards—especially their non-executive directors—make conflict all the more likely. Given the threat of litigation if they err, no wonder directors agitate and leak in order to get their way. Of course an open, harmonious board is better than a divided one in which business is done away from the table. But an open, harmonious board is not always on offer.

And that is why HP also provides a second cautionary lesson. When Ms Dunn steps down as chairman (in a feeble, face-saving compromise, she will remain until January and then become a director), Mark Hurd will add the chairmanship to his position today as the company's chief executive. Some will applaud this, arguing that what really matters for corporate success is having a good boss who is free to manage. They can point to how HP's share price has remained buoyant in spite of all the revelations.

Yet such a concentration of power is an anachronistic mistake. Nothing against Mr Hurd, who shows every sign of being a first-class manager. Yet in times of conflict—indeed while conflict is still inchoate—the chairman's job is to mediate. He can do that with more authority and impartiality as a non-executive. By contrast, a powerful chief executive will be up to his neck in any battle worth fighting. And if the chairman's sad duty is to sack the chief executive, what then? The parable of the hapless Ms Dunn makes clear that separating the two top jobs is no guarantee of a harmonious board. But, in acrimonious times, it will help.

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Accounting

The power of four

Sep 14th 2006
From The Economist print edition

The auditing profession is dangerously concentrated

Superstock

WHATEVER you might think if your accounts have ever been qualified, auditors are only human. And humans tend to exploit their power. So it is understandable that Britain's accounting watchdog revealed last week that investors and the finance directors of the country's big companies worry about the dominance of the big four auditing firms—Deloitte, Ernst & Young, KPMG and PricewaterhouseCoopers (PWC). This is not a uniquely British problem: accounting is a global profession—and it needs a global solution.

Audits are vital to investors, who need trustworthy accounts if they are to allocate capital efficiently. It is everyone's business to have confidence in what they do. Past doubts have centred on the conflicts of interest when an auditor earns large fees for selling tax advice or consultancy. And there have been welcome moves to save auditors from such temptations.

The worries that emerged this week were about choice. If one of the big four international accounting firms collapsed, some large quoted companies might be stuck without an alternative. Many companies even now have only three to choose from, because they buy non-audit services from one of the big four. Since audit firms tend to specialise by industry, some companies have no choice at all. The darker version of this theme is that the four will use their power to hold sway with litigators, regulators and standards setters. On the one hand, they dominate the profession's official bodies; on the other, they cannot be too severely sanctioned for fear that four might become an even more dominant three.

It is not an idle threat. The profession is in this pickle only because Andersen, the auditor of Enron and WorldCom, collapsed in 2002 after its conviction (later overturned) for obstruction of justice. Since then Japan's financial regulator has suspended the audit licence of PWC's Japanese arm for two months and Ernst & Young's American arm was banned in 2004 for six months from taking on new public-company audit clients for reckless and negligent conduct. It is hard to avoid the suspicion that Ernst was allowed to keep its existing clients for fear of the consequences if they were taken away. One of the reasons American prosecutors did not indict KMPG last year for its part in a case of massive alleged tax fraud may have been to avoid the risk of another Andersen-like collapse.

Imbalance sheet

Everyone has his own fix for this mess. Least appealing is one of the auditors' own proposals, that the state protect them by capping their liabilities if they are sued for damages. Academic research suggests that similar legislation in America has led auditors to cut corners and take risks. Others think the best solution is to help the second-tier accounting firms audit the big companies. The trouble is that smaller firms would invest in gaining expertise only if they had a good chance of being appointed. But, without a reputation, firms' appeal is limited.

The best way to ensure independence (and weaken the stranglehold of the big auditors) is compulsory rotation: clients should be required to appoint a new firm every seven years or so. Bring in that change and four big auditors would not seem too few. Meanwhile, regulators have no business giving big firms an easy ride just because they fear what will happen if they do what is right. If one of the big four collapses, so be it. Then the moment for drastic remedies will be at hand and the remaining big three should be split up.

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On the five-year anniversary of September 11th, palm oil, the IMF, Moscow, recycling computers, Queensland, Alaska, avoiding pregnancy

Sep 14th 2006
From The Economist print edition

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Past and present dangers

SIR – Sad to say, I found your assessment of the post-September 11th world to be lacking in both insight and courage ("Five years on", September 2nd). I can read in innumerable publications about how the war in Iraq was a mistake, that weapons of mass destruction were not found, and how the overly aggressive Americans, dragging along the reluctant Brits, have, to the world's great detriment, stirred up a hornet's nest for no reason etc, etc. Maybe *The Economist* believes that September 11th was simply an aberration and that if we had not attacked Afghanistan and Iraq, Muslim activists of various persuasions would not still both detest the West and be killing each other in dreadful numbers. Perhaps you also believe that if Israel did not exist the turmoil in the Middle East would be significantly lessened.

George Bush seems to understand that September 11th represented only the tip of a very large iceberg; that for at least the past 350 years the world has been faced with the consequences of the serious secular decline of a once great culture, which shows no indication that it has the ability to right itself. On the contrary, it has sprouted a series of radical movements (al-Qaeda, Hamas, Hizbullah, the Muslim Brotherhood, the Iranian mullahs) that, each in their own way, are attempting to restore Islam to its rightful position of dominance. The only solution out of this is to find a way to open these societies so their citizens can freely criticise their own (often autocratic) governments and embrace the positive aspects of Western thought and technology.

This is what Iraq and the war on terror are really about; placing a helpful foot on the scale on the side of those Arabs who would work with the West and gradually open their societies. Granted, the region at the moment is not a pretty picture, but al-Qaeda is on the run and Iraq, with some patience, may still turn out to be a success. Imagine the impact on other Arab nations of watching debates in the Iraqi parliament on al-Jazeera. And if we can ride out another ten years through a diplomatic approach to solving Iran's nuclear crisis, then that country's demography also points to an entirely new beginning just over the horizon.

Judd Kessler
Washington, DC

SIR – The title of your article on the war on terror was incorrect ("America's longest war", September 2nd). The Vietnam war was long and tortuous, but even counting events only from the Gulf of Tonkin resolution in 1964 to the withdrawal of American troops following the Paris peace accord in 1973 the conflict lasted some nine years. The first skirmishes in America's war of independence were at Concord and Lexington in 1775 and the decisive battle was fought at Yorktown in 1781, six years later (though the articles of peace were not signed until 1783).

The Korean war lasted for three years, but since the cessation of hostilities in 1953 no permanent peace agreement has been signed between America and North Korea. And let's not even mention the length of the cold war with the Soviets, even if it wasn't fought directly. All of these examples lasted longer than the current war on terror and its extension in Iraq, which hopefully will not obtain the distinction of becoming America's longest war.

Henrique Teixeira

Porto Alegre, Brazil

SIR – Why do you refer to the Democrats as “the American left”, “left-wingers” and “leftists”, whereas you refer to Republicans as “conservatives”? The former are articulating the centrist opinions of the majority of Americans on Iraq. And the current bunch of Republicans in power are not conservative at all: they are right-wing ideologues.

Carrie Ballard
Utrecht, The Netherlands

SIR – By focusing on the alleged limitations it faces from having to respect civil liberties, the Bush administration creates the impression that it has done all that it could, legally, to counter terrorism, when it manifestly has not (“The freedom paradox”, September 2nd). There are more steps that can be taken to bolster security that do not involve the loss of civil liberties. Funding homeland security on a needs rather than a political basis, for example, or scanning all freight at ports. And how about improving the abysmal system of communications still used among the security agencies, police and fire departments?

Gregory Murphy
New York

Environmental energy?

SIR – Whether turning food crops into fuel while people are starving is “morally appropriate” may be a matter for debate (“Fuels rush in”, August 26th). What is not at contention is that clearing rainforests to increase the cultivation of palm oil will bring ecological destruction to Indonesia and Malaysia. The use of palm oil as a substitute for diesel may appear environmentally attractive, but the destruction of biologically rich rainforests would more than outweigh the gains. A more suitable approach lies in using the oils from non-edible, drought-resistant plants, such as Jatropha and Pongamia, for biofuels.

Murali Reddy
Corvallis, Oregon

Power sharing

SIR – We agree that the IMF needs to be modernised, that its vote quotas are a distorted mirror of today's economy and that the best way to gauge relative global weight is for the fund to “give pride of place to GDP” in its new formula ("Monetary misquotations", August 26th). Your article, however, implies that our position on this issue is driven by a desire to increase our own voting share at the IMF and suggests that such a re-weighting will weaken the voice of poor countries. This is misleading.

The United States Treasury has in fact offered to forgo, in the next stage of reforms, any increase in our own voting share that would result from a new formula on quotas and we have encouraged other advanced economies to do the same (few have yet volunteered). The United States supports a significantly larger weight for GDP simply because this is the best way to recognise the increased importance of fast-growing emerging markets. We also support increasing “basic votes” to ensure low-income countries, especially in Africa, maintain a proper voice in the fund.

Mark Sobel
Deputy assistant secretary for international monetary and financial policy
Department of the Treasury
Washington, DC

Property-price boon

SIR – There is another reason why property prices in Moscow are so high (“Building a new Rome”, August 26th). The policies of the city's administration fly in the face of the federal land code, which calls for the land under privatised buildings to also be privatised. Although few municipal administrations implement this rule with any particular speed or enthusiasm, Moscow is noteworthy for defying it completely. The city still owns 100% of the land and thus all owners of buildings face a monopolistic landlord.

Jacqueline Coolidge

Chevy Chase, Maryland

Toxic advice

SIR – Recycling e-waste (computers, mobile phones and the like) does little for the environment ("How green is your Apple?", August 26th). The European Union's Restriction of Hazardous Substances (ROHS) directive will see "hazardous" materials, such as flame retardants, being removed from electronic devices just as computers are reportedly bursting into flames because of faulty batteries. The materials covered by ROHS are toxic on their own, but there is little data to suggest that they present a risk when used in computers and other devices or when disposed in landfill. There has been a European directive in force for years on the recycling of batteries. Its ten-year review assessed the costs and benefits and showed that nickel-cadmium batteries contribute less than 1% to cadmium exposure, the largest single source being fertiliser.

Gerard van Rijswijk
Sydney

Southern cross

SIR – Your suggestion that Queensland's election was called "before summer brings yet more water restrictions" ignores the fact that most of the state's rain falls in the summer months, when water restrictions are more likely to ease than increase ("Dry as a dead dingo's donger", September 2nd). The primary factor influencing the election's timing was the disarray of the opposition, which bungled an attempt to weld a coalition into a single party and then changed the leader of the junior coalition-partner. This presented an astute premier with the opportunity to seek a mandate on the water crisis, confident that voters would overlook his remarkably late discovery of the problem.

Robert King
Brisbane, Australia

SIR – Peter Beattie may well have glided to re-election on his plan to turn waste water into drinking water, but like his peers he must have caught a nasty bit of spray in his eye that is blurring his vision. Agriculture guzzles around 70% of Australia's water yet contributes to just 3% of GDP; no serious plan to tackle water security can ignore this.

William Meldrum
Taipei, Taiwan

Northern exposure

SIR – I read Lexington's opinions about Alaska being America's welfare state with interest (August 26th). I live in Ketchikan, in the far south-eastern corner of Alaska, which has been the butt of many jokes about the costly "Bridge to Nowhere" to be located here. Actually, it really is a bridge to somewhere, it's just that there isn't much there yet. The bridge is seen by many locals as a way to relieve our landlocked status, but the fact that funding for the plan comes at a time of high federal deficits (and after Hurricane Katrina) is making it politically difficult at best. It would be better if the money was spent on establishing an electricity grid in south-east Alaska, making energy more affordable and encouraging development in the area.

Lance Mertz
Ketchikan, Alaska

SIR – We have very much come to appreciate the many benefits and subsidies bestowed upon our state. So much so that we refer to one of our Republican senators, the Honourable Ted Stevens, as "Uncle Ted".

James Dainis
Anchorage

Family planning

SIR – I wasn't entirely surprised by the South African government's display of lemons and beetroot as

alternatives for the prevention of AIDS ("Beetroot but no blushes", August 26th). I once overheard a friend telling his teenage sister that the best prevention against unwanted pregnancy was an orange, held tightly between the knees all night.

Stanley Pinto
Bangalore, India

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The strange end of Tony Blair

Who killed the British prime minister?

Sep 14th 2006
From The Economist print edition

The Labour Party is kicking out its most successful prime minister for at least 50 years. Gordon Brown is both the main beneficiary and a big loser from the affair

AFP

Get article background

IF THE old saw is true that elections are not won by oppositions but lost by governments, the events of the past fortnight must have made David Cameron, the leader of Britain's Conservatives, a happy man. In that time he has seen the most potent election-winner in Labour's history—someone senior Tories still admit they do not know how to beat—humiliatingly reduced to something close to irrelevance. He has also seen Tony Blair's probable successor stained with dishonour and a once-disciplined party suffer a collective nervous breakdown. If nothing else, when Mr Cameron greets his troops at their conference next month they will know they chose a very lucky general.

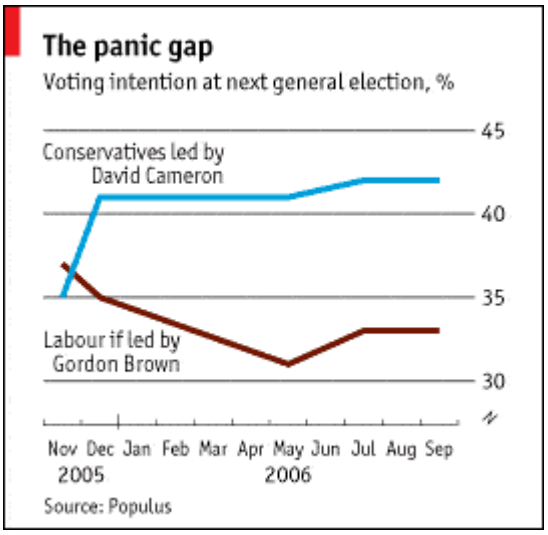
Mr Cameron can claim at least some of the credit for Labour's self-destructive frenzy. Since becoming Tory leader last December his strategy has been to remake the Conservative Party into one that uncommitted voters no longer find out-of-touch, uncaring and repellent. When not hugging trees or hoodies, Mr Cameron talks about social justice and nurturing communities, and castigates businesses that fail to meet the highest ethical standards. Under his guidance, the Tories have stopped seeking to exploit fears about immigration and promising tax cuts at the expense of cherished public services. Despite some mockery, his approach has worked well enough to give the Tories their first sustained lead in the opinion polls since 1992.

That is part of the reason for the panic that has gripped Labour, putting pressure on Mr Blair to say when he would honour his pledge to step down from his job well before the next general election. The scales were tipped by the release of a letter on September 6th signed by 15 MPs pressing him for a departure date, followed by half of them resigning their various junior government posts. Mr Blair then said he would not be in office in a year's time.

Why the panic? One of Mr Blair's unusual achievements was to have kept his party ahead in the polls, almost without interruption, for the best part of nine years in government. A consequence is that Labour MPs have become spoilt by this easy ascendancy. Under Margaret Thatcher Tory MPs grew hardened to much greater mid-term unpopularity, confident that the persuasiveness of Conservative ideas and the feebleness of the opposition would mean that their fortunes would recover when it mattered, at election

time.

But the current crop of Labour MPs, particularly the younger ones, have not learned to be resilient in the face of hard pounding. It was significant that the 15 signatories of the rude letter to Mr Blair were all from the 2001 intake. In their eyes, although no general election need be called for three years, a Tory lead that has yet to touch double figures in any mainstream poll spells disaster (see chart).



Labour has other reasons too, however, to be rid of its leader. Mr Blair has never been loved by his followers. When they chose him in 1994 they did so only because, after 15 years in fractious opposition, the party was desperate for power and realistic enough to see that Mr Blair was the man to provide it. Since then, as part of his “project” to make Labour the dominant electoral force in British politics, Mr Blair has repeatedly challenged the party's collectivist instincts. He has done so by ruling out punitive tax rates and embarking on a long campaign to revitalise the public services with money (which Labour likes) and market-based reforms (which it does not).

The unloved asset

For as long as Mr Blair was seen by his party as an indispensable electoral asset, he held sway over it. But these days many believe he has become an electoral liability. That is partly because all political leaders, as Mr Blair acknowledges, eventually reach a best-before date. Mostly, however, he has been dished by Iraq and by his uncritical intimacy with a much-loathed American president.

The sight of Mr Blair at the G8 meeting of rich-country leaders in July playing the fawning courtier to George Bush was too much for many Labour MPs. The impulse that last week turned revulsion into action came from his failure in July to join other European leaders in demanding an immediate ceasefire, as Israeli bombers pulverised southern Lebanon. This encapsulated everything about his foreign policy that makes his MPs squirm. Coincidentally, Mr Cameron this week argued for a “rebalancing” of the special relationship and a friendship with America that was “solid, but not slavish”.

Reuters

Can you sing “Yankee Poodle”?

Rolling over for Bush

It is not the war in Iraq itself, divisive though that was for Labour, or even the non-existence of the oft-cited weapons of mass destruction that has done the greatest harm to Mr Blair; it is the culpable lack of post-war planning, the ghastliness of Abu Ghraib and Guantánamo, the relentlessness of the bad news and the utter lack of contrition. Mr Blair may believe it is still too soon to judge the success of what is being attempted in Iraq, but his party holds him personally responsible for what many regard as the greatest debacle in British foreign policy since Suez, 50 years ago. It is a measure of Mr Blair's isolation that he admits to having been surprised by the backlash over Lebanon, but he is unrepentant, convinced

that popular opinion simply misjudges the scale of the threat from Islamist terrorism. His defiance—he says these issues are “non-negotiable”—is seen by many MPs as a continuing provocation to the party and its supporters.

For a few, the deep embarrassment of a party-finance scandal has provided a further reason for Mr Blair's removal. In his long-running battle to reduce the influence of the unions, Labour's traditional paymasters, Mr Blair hoped that the subscriptions of ordinary party members and the donations of the rich, gratified by the government's pro-business stance, would reduce the party's dependence on organised workers. But as party membership fell (in part because of Iraq), the reliance on rich individuals increased. For most of the past year the police have been investigating the possibility that peerages have been offered in exchange for loans. The awful, though remote, possibility hangs over the prime minister of leaving Downing Street in the back of a police car.

If those were the immediate causes of the attempt by a section of his party to bring down the prime minister, it still does not provide quite the whole explanation. Mr Blair had given private assurances to close colleagues, including the chancellor, Gordon Brown, that he would be off by next summer. Why then risk the certain collateral damage that a putsch would cause to bundle Mr Blair out of office a few months early? And was Mr Brown, if not pulling the strings of the rebellion, acquiescent in it?

Last weekend Mr Brown claimed that he had given the plotters no encouragement. Had he known of the letter and planned resignations from the government, he would have said it was “completely ill-advised”, he avers. Unfortunately for the chancellor, few, especially those close to Mr Blair, are inclined to believe his protestations of innocence.

The revelation that Tom Watson, the most notable of the signatories and an acolyte of Mr Brown's, visited the chancellor at home in Fife the day before the letter was faxed to Downing Street is deeply embarrassing for the chancellor. Apparently, Mr Watson made the 1,000km (600-mile) round trip just to drop in on the Browns and give them a present for their new-born son, Fraser, and politics was the last thing on their minds. This is about as convincing as Mr Brown's explanation for being photographed with a vulpine grin on his face as he left Downing Street after one of two showdown meetings with Mr Blair last week: he had just been talking about “nannies, babies...nothing to do with politics”, he said.

If Mr Brown was not as distant from the plot as he wants people to think, then he is guilty of an appalling miscalculation. Two or three weeks ago, with only a few exceptions, the cabinet and rising young Blairite ministers were determined to make the best of Mr Brown's near-certain succession. The prospect may not have filled every heart with gladness, but most were hopeful that Mr Brown might become easier to work with—more relaxed, more open, less inclined to listen to only a handful of chosen favourites—once he had the top job. And given that their own prospects and those of the party depended on his success, they would do whatever they could to help and support him. All that has now been put in jeopardy.

A matter of temperament

As Mr Blair and Mr Brown stepped back from the brink at the end of last week—the prime minister by unhappily committing himself publicly to stepping down next year, the chancellor by disingenuously declaring that Mr Blair must be allowed to decide the date of his departure—Charles Clarke dared to say what many were whispering. In two newspaper interviews the former home secretary, who was dumped by Mr Blair a few months ago for failing to get to grips with the administrative chaos in his department, denounced Mr Brown's behaviour. Describing that triumphalist smirk as “stupid, absolutely stupid”, he went on to cast further doubt on the chancellor's fitness for the highest office.

According to Mr Clarke, Mr Brown had for years clung to the “delusion” that he could have beaten Mr Blair for the leadership; he was “totally uncollegiate”, lacking in “courage” and had “psychological” issues. Mr Clarke painted a picture of a brooding presence who, for all his talent and ability, had frequently undermined the work of colleagues and the effectiveness of the government. Mr Brown's riposte was that inevitably some cabinet colleagues had become resentful as it had often been his job to deny them money. This would have been more persuasive had the Treasury not dispensed so much largesse so freely over the past six years.

Mr Clarke's attack was doubly devastating because nobody could accuse him of acting on behalf of Mr Blair, since he was only saying in public what other ministers had been muttering for years. Despite the eagerness in some quarters to be shot of Mr Blair, plenty of people who have seen Mr Brown close up agree with the verdict of one cabinet minister, that unless the chancellor can change his modus operandi

dramatically he will make a terrible prime minister.

It is Mr Brown's character and temperament as much as his probable policies that make some of his colleagues, not least Mr Blair, uncomfortable about the prospect of his succession. As far as those policies are concerned, Mr Brown has been remarkably opaque for years. Although he often talks about further reform of the public services, the last time he presented a comprehensive account of his ideas on the subject was more than four years ago, when he appeared to question how far competition and choice could be taken in health and education. Since then he has often seemed happy to allow those opposed to Mr Blair's attempts to bring about change in the public sector by introducing market disciplines to think he might agree with them. That he almost certainly does not makes his past behaviour both stranger and less admirable.

Indiscriminately unchummy

If anything, he has had even less to say about foreign affairs. He signals that he would be no less robust than Mr Blair in fighting terrorism. And though his natural caution would have made him less eager for military adventures abroad, there is no reason to suppose that he would bring back British troops from Iraq or Afghanistan any faster than Mr Blair.

Mr Brown might not be quite as chummy with Mr Bush as Mr Blair has been, but then he is less chummy with almost everybody. He is instinctively pro-America, however, admiring its economic dynamism and capacity for moral uplift. His Europeanism, on the other hand, is tempered by his dislike of the meetings he attends with his European Union counterparts (rarely concealed) and frustration over the lack of zeal among some of them for economic reform. But he has left it to commentators to connect the dots rather than spell out himself what he believes.

At a time when ideological differences between the parties, or at least between their leaders, are too subtle for most voters to discern and class solidarity with specific parties has weakened, questions of character may now become all important. The real significance of this month's events is not that Mr Blair has lost the ability to control his political destiny but that Mr Brown's complicated personality has become the central issue in British politics.

Would Mr Bush ever have become president if voters in America had not found the better-qualified Al Gore stiff and chilly? In Britain, a year ago, David Davis appeared to have the Conservative leadership election sewn up. But the moment, at the annual party conference, that a credible challenger emerged in the shape of Mr Cameron, there were enough Conservatives who remembered reasons to dislike Mr Davis—“disloyal” and “bully” were two words suddenly applied to him—for the air to hiss quickly out of his campaign. Mr Cameron conveyed freshness and charm; Mr Davis, staleness and menace. What then guaranteed Mr Cameron's victory was the evidence of poll after poll that the party would do better under his leadership than under Mr Davis's: the more voters saw of the young Mr Cameron, the more they preferred him to a grizzled machine politician.

Blairites who have long been infuriated by what they regard as Mr Brown's destructive and graceless behaviour reckon that, faced with a plausible rival, Mr Brown could perhaps suffer a similar fate. They were encouraged by a poll by Populus published in the *Times* newspaper last week which suggested that John Reid, the bullishly self-confident home secretary, would do as well as Mr Brown against the Tories, despite being far less known. The reason, according to someone close to Mr Blair, was that voters could see in Mr Reid a natural leader.

Mr Blair himself is said to think that the young environment secretary, David Miliband, might be Labour's best answer to the appealing Mr Cameron, though Mr Miliband says he does not want to stand. Another much bruited name is that of Alan Johnson, the education secretary (see article). A former union leader, Mr Johnson does not suffer, as do Mr Brown and Mr Reid, from the disadvantage of being a Scot in post-devolution England. Mr Johnson is also immensely likeable. As one admirer puts it, “He's a fully paid-up member of the human race, unlike Gordon.”

The danger of being Browned off

Whether they, or anyone else, will actually challenge Mr Brown for the leadership is still far from certain, for three reasons. First, a candidate must have the support of 44 MPs in order to stand. Though Mr

Brown is now trying to persuade people that he positively welcomes an open contest, as long as he remains the favourite to succeed Mr Blair only the reckless or terminally unambitious are likely to come out in favour of an opponent. Second, Mr Brown has been the heir-apparent for so long that it would be a wrench for party activists and the members of affiliated trade unions to back another. On September 12th, hours after Mr Blair had been heckled and insulted at the Trades Union Congress, union leaders were cooing over Mr Brown, even though he had made clear his support for the prime minister's uncompromising reformist message. Third, as the financial steward of a government that has spewed out cash for Labour's dearest causes, many feel they owe him a debt of gratitude.

That could change if it becomes clear that Mr Brown's already questionable rapport with the electorate has taken a further dive as a result of recent events. It could also change if the sullen truce within the party that has held since the weekend fails to last. In all probability, though, the crown will still pass to Mr Brown. Whether the voters will forget before polling day what they have learned this month about their next prime minister is another matter. Many people will be eager to remind them, not least the charming, lucky Mr Cameron. As Mr Brown knows better than most, politics is a brutal business.

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Foreign policy

In the world of good and evil

Sep 14th 2006 | WASHINGTON, DC
From The Economist print edition

America's foreign policy seems strongly influenced by religion. But that influence is much more complex than its critics suppose

Getty Images

SEPTEMBER 11th 2001 drew the transatlantic alliance together; but the mood did not last, and over the five years since it has pulled ever further apart. A recent poll for the German Marshall Fund shows that 57% of Europeans regard American leadership in world affairs as “undesirable”. The Iraq war is mainly to blame. But there is another and more intractable reason for the growing division: God.

Europeans worry that American foreign policy under George Bush is too influenced by religion. The “holy warriors” who hijacked the planes on September 11th reintroduced God into international affairs in the most dramatic of ways. It seems that George Bush is replying in kind, encouraging a clash of religions that could spell global catastrophe.

Dominique Moïsi, a special adviser at the French Institute for International Relations, argues that “the combination of religion and nationalism in America is frightening. We feel betrayed by God and by nationalism, which is why we are building the European Union as a barrier to religious warfare.” Josef Braml, of the German Institute for International and Security Affairs, complains that in America “religious attitudes have more of an influence on political choices than in any other western democracy.”

The notion that America is too influenced by religion is not confined to the elites. Three in five French people and nearly as many Dutch think that Americans are too religious—and that religion skews what should be secular decisions. Europeans who think that America is “too religious” are more inclined to anti-Americanism than their fellow countrymen. Thirty-eight per cent of Britons have an unfavourable view of America, but that number rises to 50% among people who are wary of American religiosity.

Is America engaged in a faith-based foreign policy? Religion certainly exerts a growing influence on its actions in the world, but in ways more subtle and complicated than Europeans imagine.

It is true that America is undergoing a religious revival. “Hot” religions such as evangelical Protestantism and hardline Catholicism are growing rapidly while “cool” mainline versions of Christianity are declining. It is also true that the Republican Party is being reshaped by this revival. Self-identified evangelicals provided almost 40% of Mr Bush's vote in 2004; if you add in other theological conservatives, such as Mormons and traditional Catholics, that number rises closer to 60%. All six top Republican leaders in the Senate have earned 100% ratings from the Christian Coalition.

It is also true that Mr Bush frequently uses religious rhetoric when talking of foreign affairs. On September 12th he was at it again, telling a group of conservative journalists that he sees the war on terror as “a confrontation between good and evil”, and remarking, “It seems to me that there's a Third Awakening” (in other words, an outbreak of Christian evangelical fervour, of the sort that has swept across America at least twice before). And Christian America overall is taking a bigger interest in foreign policy. New voices are being heard, such as Sam Brownback, a conservative senator from Kansas who has led the fight against genocide in Darfur, and Rick Warren, the author of a bestseller called “The Purpose-Driven Life”, who is sending 2,000 missionaries to Rwanda.

Finally, it is true that religious figures have done some pretty outrageous things. Pat Robertson called for the assassination of Hugo Chávez, the president of Venezuela. Lieutenant-General William “Jerry” Boykin, deputy under-secretary of defence for intelligence, toured the country telling Christian groups that radical Muslims hate America “because we're a Christian nation and the enemy is a guy named Satan”. He often wore uniform.

Refuting the preachers

Yet there are qualifications to this picture. First, Mr Bush has frequently crossed his religious supporters. In his enthusiasm for trade with China, he brushed aside evangelicals' worries about government persecutions of Christians. Rebuffing several powerful preachers, such as Franklin Graham and Jerry Falwell, he insists that Islam is a “religion of peace”. He makes a point of visiting Islamic religious centres (including a visit within a week of the September 11th attacks) and involving mosques in faith-based initiatives.

America's foreign-policy elite is also one of the most secular groups in the country. Douglas Johnston, a former Defence Department official, calls religion “the missing dimension in statecraft”. Mr Bush's most controversial policy, the Iraq war, arguably rested on a failure to take religion seriously enough. The administration was preoccupied with the idea that terrorism had state sponsors—hence the desire to remove Saddam Hussein. It also argued that reordering the Middle East might wean people off radical Islam. But both ideas ignore the fact that Islamic extremism is at base a religious movement. Holy warriors don't need state sponsors to be effective. And democracy may well hand power to religious extremists.

Third, many outsiders hate America not because of its religiosity but because of its highly secular pop culture. In Pakistan 60% of the public has an unfavourable view of the United States. But the proportion rises to 75% among people who think that America is insufficiently religious. America makes enemies, therefore, as much because it lacks morality as because it seems soaked in it.

Critics of America's “faith-based” foreign policy make two errors. They lump all religious Americans together into one mass, and then confound the lumping by quoting the wackiest people they can find. (Oddly, many of the worst lumpers are the first people to insist on the importance of distinguishing between radical and moderate Islam.)

Walter Russell Mead, of the Council on Foreign Relations, points out that America is so rich in religion that you can quote a religious person in support of every political position imaginable. He also makes a vital distinction between fundamentalists and evangelicals. Fire-and-brimstone fundamentalists such as Mr Falwell and Mr Robertson get all the press; but evangelicals, while also embracing biblical literalism, are both more temperate and much more inclined to think that sensible policy can improve the world.

Ethical impulses

The second error is to overestimate the influence of religion on Americans' views of foreign policy. A succession of polls by the Pew Research Centre has shown that religion has little direct influence on the average American's views of foreign policy. In 2003 only 10% of Americans said that their religious beliefs shaped their opinions on the Iraq war. Americans consistently say that the media have more influence on their views of foreign policy than religion does.

So what role does religion play in shaping foreign policy? The Euro-secularists are right about one big thing—the influence of religious groups on policy toward Israel. Americans support Israel for lots of secular reasons too, including sympathy for a nation of settlers and the strength of the pro-Israel lobby

in Washington. But the booming evangelical movement, convinced of the vital importance of Israel in divine planning, provides a solid core of popular support.

The Euro-secularists are usually blind to the other big influence of religion on American foreign policy. Christians are at the forefront of attempts to make American foreign policy more ethical. They have encountered fierce resistance from the realists in the State Department (particularly over deeper involvement in Darfur) and from business Republicans (particularly over China). But they have significantly increased the size of the constituency that favours a moral foreign policy.

Evangelicals have campaigned against sex-trafficking and drug-trafficking, against poverty and religious persecution, and against the genocide in Sudan. They have led the charge to deal with AIDS in Africa (the person who did most to persuade Mr Bush to pledge $15 billion to that cause was his former chief speech-writer, an evangelical who has been dubbed “the conscience of the White House”). A group of leading evangelicals recently signed a statement on climate change proclaiming that the problem is real, that human activity is an important cause, that the costs of inaction are high, and that those costs are disproportionately borne by the poor.

American religiosity also has a more indirect influence on foreign policy. It predisposes Americans to look at the world in certain ways—to regard America as a special nation and to see the world in terms of a struggle between good and evil. These tendencies have always been there. But they have arguably become more pronounced since the September 11th attacks. Vice-President Dick Cheney claims, of the “war on terror”, that “the United States and only the United States can see this effort through to victory.” The National Security Strategy of the United States of 2002 states boldly that “our responsibility to history is already clear: to answer these attacks and rid the world of evil.”

This religious colouring of American foreign policy is unlikely to change. Americans have always interwoven religion with their actions in the wider world—from the missionaries who carried Christianity abroad in the 19th century to Dwight Eisenhower's denunciation of “Godless communism” in the 1950s. But it should not be forgotten that Americans also have a genius for mixing realpolitik with their religion.

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Religion

The God slot

Sep 14th 2006
From The Economist print edition

The complexities of a simple, and almost universal, belief

WHEN Homer Simpson opted out of church once, staying home to watch football and eat waffle-batter, he dreamed that God peeled off the roof of his house and appeared, furious, in the TV room. According to a new survey, 31% of Americans see God that way. He (always he) is wrathful and ever-watchful; He wants his followers to stop sinning, and thinks government should be promoting Him. In the South, 44% of people go in fear of His lightning bolts.

The survey, by Baylor University's Institute for Studies of Religion in Waco, Texas, via Gallup, found four broad views of God in America. Homer's Authoritarian God is the most popular. There then follow, in descending order of intrusiveness, Benevolent God (23%, rising to 29% in the Midwest), who still gives orders but will forgive, rather than smite; Critical God (16%, but 21% in the relativist East), who watches the world but does not intervene; and lastly Distant God (24%), a cosmic force without interest in human matters. This God is especially popular in the wide open West, with its huge views of the stars.

Baylor is a Baptist school with a strong evangelical slant, but only 15% of Americans call themselves evangelicals. Many more (47%) prefer the fervent “Bible-believing”. About 11% profess no religious ties at all; but 63% of those still believe in a higher power, and only 5% dare embrace the title “atheist”. Belief in God, or some equivalent force, comforts more than 90% of the population. And 19% agree that “God favours the United States in international politics”.

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Katrina evacuees in Texas

A cooling welcome

Sep 14th 2006 | HOUSTON
From The Economist print edition

Rising crime frays Houston's nerves

BILL WHITE, the mayor of Houston, Texas, won high praise for opening his city to the bedraggled evacuees from New Orleans last year. But the welcome from Houstonians has worn painfully thin. At a community meeting in late August, Mr White and the police chief got an earful from 1,700 West Houston residents fed up with rising crime. “It just doesn't feel real good to be out here right now,” said Jeannie Bollinger of West Houston's chamber of commerce, who was at the meeting. Others who were there railed against subsidies from the Federal Emergency Management Agency (FEMA) and urged Mr White to send the evacuees home.

Houston remains home to over 120,000 people displaced by last year's monster hurricanes, Rita and (mainly) Katrina. At the height of the tumult, 250,000-300,000 refugees were in the city. Many have found work and settled in. Others have not. Some 30,000 families still survive on housing subsidies from FEMA. Around 30% of the newcomers are elderly or disabled.

Tensions have come to a head over crime. In fast-growing West Houston, as Ms Bollinger acknowledges, the problems predate Katrina. When cow pastures gave way to strip malls and suburban subdivisions, undesirable behaviour increased too. There were “lots of things West Houstonians had never seen before”, such as begging and prostitution. But Katrina evacuees have brought more violent crime, says Ms Bollinger. Houston's murder rate had been falling in recent decades, but now it is rising again. Some 58 of 261 murders up to August 24th this year have been linked to Katrina people. If the rate continues, murders for the year would exceed 400; last year there were 334. (Murder numbers jumped nearly 5% nationwide in 2005 after a long decline, according to FBI figures released this week.)

Even Kinky Friedman, a singer and entertainer who is running a bizarre independent campaign for governor of Texas, has thrown in his two cents. “The musicians mostly have moved back to New Orleans now,” he says. “The crackheads and the thugs have decided to stay here.” (Under fire later, he explained that he doesn't pander to ethnic groups: “I don't eat tamales in the *barrio*, I don't eat fried chicken in the ghetto, I don't eat bagels with the Jews for breakfast. That to me is true racism.”)

Mayor White—who is so popular that he was re-elected last November with more than 90% of the vote—insists that more boots on the ground will help. People are being arrested in record numbers, he says, even for “some minor infractions that may have been tolerated in the New Orleans area”. He adds that police numbers are meant to rise by about 10% over the next few years. In the West Houston apartment complexes near where evacuees live police cars are already highly visible. Meanwhile some neighbourhoods are considering citizens' patrols, according to Ms Bollinger.

No one, including the mayor, is surprised that the honeymoon is over—but could things get worse? Many Katrina evacuees still want to return home, but much will depend on the precarious housing situation in New Orleans. Deirdra Sampson, a Houston social worker (and herself a New Orleans evacuee), says that people yearn for the tight communities of the Big Easy, where all family members often lived within a mile of one another. “It takes 30 minutes to get everywhere in Houston,” she sighs.

Living in Houston is also about to become tougher for those without jobs. On October 31st evacuees must re-certify their eligibility for FEMA subsidies. A hard deadline in February 2007 is supposed to end all FEMA-subsidised housing. What then? Mr White insists that Houston, though it will be patient with evacuees seeking jobs, will not take up the slack on housing. “The city simply cannot be in a position of subsidising the nation's housing programme for evacuations,” he says.

Still, it is unlikely that everyone, especially the elderly, the disabled and single mothers, will have found

jobs. Mr White argues that a new federal bureaucracy needs to be in place—leaving FEMA as the “shock troops” for debris removal and temporary shelter, but perhaps creating another agency to co-ordinate longer-term housing, education and health care for displaced people. Congress may be forced to grapple with the matter next February.

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The District of Columbia

Learning to vote

Sep 14th 2006 | WASHINGTON, DC
From The Economist print edition

The capital's continuing struggle for proper representation

RECENT polls suggest that almost two-thirds of Americans are dissatisfied with their representatives in Congress. Residents of the District of Columbia are unhappy for a different reason: they have no representative. No senators, either. Currently, the District's congressional presence consists of one non-voting delegate, Eleanor Holmes Norton. A United Nations human-rights committee recently said it was “concerned” about the situation. But it is enshrined in the constitution: Congress has legislative authority over the seat of the federal government, and only states have senators and representatives.

For many residents of the District, the lack of congressional representation is just another quirk of life in the area. Others are less resigned to being voteless. In 1987 Walter Fauntroy, then the DC delegate, complained that the Soviet Union “embraces the citizens of Moscow with an equality that the US denies to every Washingtonian”. Today Representative Tom Davis of Virginia compares giving the District a representative to the pursuit of democracy in Iraq and Afghanistan. Mr Davis is the sponsor of the DC Fairness in Representation Act, which is currently making its way through the House.

Supporters of the bill point out that although the District is not a state, it has more people than Wyoming and they pay taxes. In 2000 the city introduced licence plates complaining of “Taxation Without Representation” in the space typically reserved for state boosterism. Bill Clinton had them installed on the presidential limousine, but George Bush had them removed shortly after his inauguration.

Previous efforts to give the District a representative have never got off the ground. Republicans have resisted efforts to hand political power to a city whose overwhelmingly black residents vote Democratic. The new bill seeks to disarm Republican opponents. Mr Davis is a Republican himself, and his plan is to add two new representatives to the House: one for the District and one for Utah, which is heavily Republican. From a political perspective, the two new representatives would cancel each other out.

The next hearing on the bill was due on September 14th; everything depends on how quickly the House moves forward. In the meantime, Washingtonians looking for local political excitement will have to find it in the race for mayor—an event the city has enjoyed only since 1973, when Congress decided to let it have one.

Because the District is so heavily Democratic, it holds its election two months early; all the action is in the party primary. On September 12th Adrian Fenty, a member of the city council, won the primary, and will almost certainly become DC's fifth mayor. In a drab field, Mr Fenty stood out for his fresh face and his dogged pursuit of the nomination. In June 2005 he began going door to door, which he considers the “purest” form of campaigning. He estimates that he has knocked on over half the doors in the District.

It is clear that he has a hard job ahead of him. In addition to the special annoyances of working directly under the federal government, the mayor of Washington has to deal with the usual problems of a big city. This summer, armed robberies of tourists drew attention to the District's high crime rates. Last year, only 28 of its 146 public schools met local academic benchmarks.

At 35, Mr Fenty will be the youngest mayor the District has had, and his age sometimes shows. Public speaking makes him visibly nervous, and fellow council members complain that he keeps himself entertained in legislative sessions by BlackBerrying.

The *Washington Post*, endorsing Mr Fenty, was optimistic about his “can-do quality”. But if he comes up short, he can take comfort in the fact that the bar for DC mayors is relatively low. Marion Barry held the office for more than ten years before he was caught on video smoking crack and had to step down. That

happened in 1990. He was re-elected in 1994.

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About sponsorship

Pittsburgh

How now brown town?

Sep 14th 2006 | PITTSBURGH
From The Economist print edition

A former steel city is now proclaiming its cleaner land and clever minds

A FEW years ago, the Pittsburgh region was so desperate to hang on to its brightest young people that its boosters thought about running television ads featuring “Border Guard Bob”, a patrolman who would have stopped youngsters on their way out of town and urged them to stay. Wisely, the boosters scrapped that idea. And increasingly it seems as though the worries were misplaced anyway. Many of the graduates from Pittsburgh's 34 universities—led by Carnegie Mellon and the University of Pittsburgh—do stick around, and some of them are finding work in cutting-edge scientific fields. A couple of decades after the collapse of the local steel industry prompted many Pittsburghers to flee, the city has a rosier future.

Pittsburgh will not experience an explosion of population and investment, like the booming cities of America's south-west. But it is part of a pleasant and affordable region with an improving mix of industries and enviable demographics—which is as much as many parts of the country can hope for. And besides shaping young minds, Pittsburgh is also doing its best to reshape old land, by cleaning up former mining and industrial sites for uses that suit the modern economy.

One place where these two trends converge is in the SouthSide Works development, a 34-acre (14-hectare) collection of shops, offices and living space being built on the site of an old LTV steel plant on the Monongahela river. The idea, which is popular in many other American cities, is to try to create an area close to the centre of town where young professionals can live and play, as well as work. That might improve Pittsburgh's appeal to creative or knowledge-intensive workers—and those who employ them.

The SouthSide Works aside, however, plenty of clever young people already seem to be staying. Although the region's overall education levels are not that impressive, says Chris Briem, an economist at the University of Pittsburgh, those figures are partly skewed by its high ratio of elderly residents. Among Pittsburghers 25-34 years old, by contrast, 41.9% have graduated from university, placing the city among America's top ten. More than 17% of those young people have also earned an additional graduate or professional degree: the fourth-highest share in the country, behind only Washington, DC (think lawyers), Boston and San Francisco.

Much of Pittsburgh's drive to clean up brownfield sites is more mundane than SouthSide Works, or the engineering and biotech labs in the city's universities. But it is nonetheless useful in updating and

rounding out the local economy. The city has plenty of land near the airport, for example, that will soon be accessible on a new highway spur connected to the interstate system. That could be appealing to companies looking for new places to put distribution centres—a crucial bit of America's logistics-driven economy. Some of this land is undercut by old mines, so the government is blasting the mines open, filling areas back in and then flattening them out.

These efforts have a clear logic to them. Pittsburgh is within one day's drive, or a short flight, of the whole eastern seaboard, which accounts for more than half of America's retail sales. But it has lower costs than the big coastal cities. Its potential appeal as a logistics hub thus gives it a fighting chance of attracting the sort of distribution investments that have helped such cities as Louisville, Kentucky and Memphis, Tennessee, though on a smaller scale. A few thousand such jobs would help many locals with moderate levels of education. The city is already showing off a sprawling distribution facility for Dick's Sporting Goods, a big retailing chain.

As Pittsburgh upgrades its local economy, it will increasingly have demography on its side. Because so many prime-age workers moved away in the early 1980s—often taking children with them—it now has lots of old folk. At the last census, in 2000, 15.6% of Pennsylvania's population was over 64 years old—second only to Florida—and the Pittsburgh region is older than the rest of the state. But now the Grim Reaper will even things out. Over the next quarter-century, however, the Census Bureau expects Pennsylvania's over-64 population to grow by only 50%, the smallest increase of the 50 states. The national elderly population will grow more than twice as quickly, while that of currently vibrant states in America's south-west will explode. When today's most glamorous regions begin to face that brutal arithmetic, many of today's young Pittsburghers may be glad they stayed put.

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Rice farming

Grains of doubt

Sep 14th 2006 | LITTLE ROCK
From The Economist print edition

A tale of high-tech contamination in the bins of Arkansas

GENETICALLY altered crops slipping into the food chain; foreign countries placing restrictions on imports; farmers in rural America panicking. It has happened before, with corn. Now America's rice-farmers are facing a similar drama.

In late July, American agriculture officials and food safety authorities learned that unapproved rice had been found in commercial bins in Arkansas and Missouri. The rice—known as LLRICE601—had been genetically modified to resist certain herbicides by Bayer CropScience, which is based in Germany. As a result, the European Union is demanding proof that long-grain imports are not contaminated with LLRICE601, which was tested between 1998 and 2001 in the United States but never marketed. The EU now wants rice tested by an accredited laboratory using “a validated testing method” and accompanied by a certificate. Japan has banned all imports of American long-grain rice.

This is bad news for Arkansas, where rice paddies cover around 1.5m acres. It is the state's main farm export, adding about $1.55 billion yearly to the economy and generating an estimated 20,000 jobs: quite a few of them at Riceland Rice, the world's largest miller and marketer of the stuff.

Riceland became aware of the genetically altered rice in January, when a customer alerted the 9,000 farmer-member co-operative about possible contamination. Riceland sent a sample for testing to a laboratory; it tested positive for the herbicide-resistant trait. Further tests confirmed it, and in June Riceland contacted Bayer.

According to Riceland, genetically engineered rice has never been produced commercially in America. The company, in a press release, said it suspected that “the material would be identified as residual fragments of genetically engineered corn or soybeans resulting from use of common public transportation systems.” Because of the small amount of evidence, the laboratory could not tell where the rogue rice had come from. Federal officials stress there are no “health, food safety, or environmental concerns”, and the secretary of agriculture, Mike Johanns, has admitted that 70% of all processed foods currently on grocery shelves contain genetically engineered ingredients.

It would all be a fuss about nothing, then, were it not for the reaction of the EU and the Japanese. The American rice crop this year could be valued at $1.88 billion. Half of that is exported, according to the Department of Agriculture, and about 80% of those exports are long-grain varieties. American growers account for about 12% of the world rice trade.

A group of farmers have now filed a class-action suit asking Bayer to clean up the contamination. The suit, filed in district court in Little Rock, also demands compensatory and punitive damages for rice-growers affected by the incident. Bayer has said it has no plans to market LLRICE601. Yet the company has petitioned for a deregulation process by the Animal and Plant Health Inspection Service, including a period for public comment, which began this week. According to the USDA, more than 70 genetically engineered crop lines have been deregulated since 1987.

The fallout continues. This week the EU urged intensified testing of products already on the market and extensive reporting on the results. Greenpeace, a green pressure group, said it had found traces of LLRICE601 in rice sold in German supermarkets. Germany imports one-quarter of its rice from the United States.

The Arkansas legislature will probably take up the matter in January, and will presumably back the farmers' demands for a clean-up. But once genetically modified foods are out in the environment it is

pretty hard to recall them, regardless of what politicians would like.

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Lexington

The independent man

Sep 14th 2006
From The Economist print edition

Lincoln Chafee is one of the last of a different kind of Republican

THE Rhode Island statehouse is topped off with a large bronze statue called “the independent man”. Rhode Islanders like what he stands for. From the start the state was a refuge for religious dissenters—“the sewer of New England” in Cotton Mather's phrase. Rhode Island refused to send delegates to the 1787 Constitutional Convention, and delayed joining the union until after the other 12 states.

This week saw Rhode Island's very independent senator survive an unusually spirited primary challenge. Lincoln Chafee is by no means as impressive as the statue. He is diffident to a fault. He inherited his Senate seat from his father, a man who had been the state's governor before becoming its senator, and whose memory continues to be much honoured. Asked what they think of the senator, Rhode Islanders have a habit of politely replying that they liked his father.

But there is no doubt about his independence—at least from the national Republican Party. He was the first Senate Republican to raise doubts about George Bush's tax cuts. He voted against the Iraq war and sundry bits of social conservatism. In the last election he refused to vote for Mr Bush, writing in the president's father's name instead. Only last week the Senate Republicans delayed a committee vote to confirm John Bolton as UN ambassador at Mr Chafee's request.

Mr Chafee has boasted that his support for Mr Bush has been “spotty at best”. His fellow Republicans call him the “missing link”. The American Conservative Union gave him a rating of 12 (out of a possible 100) in 2005, the same as Hillary Clinton and one point behind Russell Feingold, who is positioning himself as a champion of the Democratic left in the 2008 presidential race. The Club for Growth, an anti-tax group, was so infuriated with him that it spent $1m backing Stephen Laffey, his opponent in the Republican primary.

The race was full of ironies. Mr Chafee made a point of encouraging Democrats to disaffiliate from their party for the day in order to vote for him. Mr Laffey remained true to hard-core Republican principles: anti-tax, pro-life and so enthusiastic about the free market that he has named his dog “Milton” after Milton Friedman. He was also an embodiment of new model Republicanism: the son of a local machine-worker who went to Harvard Business School and made a fortune in investment banking, and a tireless

campaigner who wore out three pairs of running shoes going from door to door.

But the Republican establishment backed the “missing link” to the hilt. The party showered him with more than $1.2m. It sent Laura Bush and other Washington figures to campaign for him. It provided him with campaign workers and get-out-the-vote specialists. And it relentlessly criticised Mr Laffey for various heresies—including raising taxes as mayor of Cranston. Thus Mr Chafee has survived to fight another day with the help of cash from a party where he is not at home and with the votes of 14,000 or so people who belong to the other side.

Mr Chafee's victory represents a rare bit of good news for the Republicans, as the polls hint at simmering anger against the ruling party. A conservative activist like Mr Laffey had no chance of winning in a state where less than 15% of the voters are registered Republicans and Mr Bush's approval rating is 22%. Mr Chafee faces a tough fight in November against the Democrat, Sheldon Whitehouse, who has more money in his pocket (about $1.5m) and a pumped-up party behind him. But his golden name, moderate record and position as an incumbent give him a fair chance of winning, a chance that was boosted by Mr Laffey's noble announcement that he will campaign for him.

There are many reasons for even non-Republicans to hope that he can survive. The Chafees of this world are good for the health of the Republican Party. They help to keep it a big-tent gathering rather than a claustrophobic clique—the party of Rudy Giuliani and Arnold Schwarzenegger as well as of social conservatives. They are also good for the health of American politics in general. People like Mr Chafee—who experience the cross-pressures of their conservative parties and their liberal electorates—have proved to be some of the great bridge-builders in a divided Congress. They are also some of the great bridge-builders between red and blue America.

The Rockefeller example

America is in danger of turning into a collection of one-party states—Republican ones that are controlled (thanks to the primaries) by the reddest of the red and Democratic states that are controlled by the bluest of the blue. Mr Chafee keeps Rhode Island competitive (he has been the only Republican in the state's congressional delegation since he took over from his father). He also represents a valuable political tradition that is in danger of disappearing: Rockefeller Republicanism. This tradition is much keener on good government and fiscal responsibility than the southern-fried version of Republicanism, but also much more responsible and wise than college-town liberalism about international affairs.

And it is dying out fast. Republicans of this stripe are great survivors—Mr Chafee's WASP family has weathered the transformation of Rhode Island into the most Catholic and Democratic state in the country, and the conversion of his party from Rockefeller Republicanism to Reaganism. But Rockefeller Republicans are facing an ever more hostile world. Vermont's Jim Jeffords left the Republican Party to become an independent. Christine Todd Whitman had a miserable time as Mr Bush's environment secretary. Two prominent New England congressmen, Christopher Shays and Rob Simmons, face tough re-elections. The next Congress could well be even more polarised than the last—and even more in need of people like Lincoln Chafee.

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Canada

This land is my land

Sep 14th 2006 | OTTAWA
From The Economist print edition

Yet another land-claim dispute turns ugly and shines a spotlight on the failure of Canada's policies towards its aboriginal people

Corbis

CANADA'S much vaunted reputation for tolerance took a beating this summer in Caledonia, a town 80km (50 miles) south-west of Toronto, where a new housing development on land claimed by the Six Nations Iroquois Confederacy has sparked off a series of ugly clashes between the aboriginals and the town's non-indigenous residents.

The land is part of a much larger tract given by the British to their Indian allies from New York in 1784 when members of the tribes fled to Canada after the American war of independence. Claiming that the land was thereafter sold without their proper consent, members of the Six Nations have been occupying the site for the past six months, setting up barricades and blocking traffic. This, in its turn, has provoked a series of counter-blockades, brawls, vandalism, and a fight with golf balls and stones. In a belated attempt to avert further violence, the provincial government bought the contested property from the private developers in June and opened negotiations with the Six Nations. But tensions in the town spiked again at the end of last month when the protesters threatened to complete the 11 unfinished homes themselves and to live in them throughout the winter.

Because Caledonia is (by Canadian standards) on the doorstep of Canada's largest city, the conflict has been attracting blanket media coverage. But few have bothered to trace its origins back to their source: the spectacular failure of overall aboriginal policy. Treating their 1m indigenous citizens fairly should be the “ultimate moral issue for Canadians”, says Paul Martin, the former Liberal prime minister. Instead, they are treated with a mixture of ignorance and indifference. The current policy, based on “white guilt and aboriginal anger”, does not work, argues John Richards of Simon Fraser University.

Canada's current philosophical approach is a far cry from the 1969 attempt by Pierre Trudeau, another former prime minister, to assimilate the country's aboriginals by abolishing separate Indian status and, with it, any right to special treatment by the state. Aboriginal anger forced Mr Trudeau to climb down. By 1982 he had had a change of heart, enshrining broad aboriginal rights in the new Canadian constitution. Assimilation as an official policy died, although it is still favoured by some academics, including Tom Flanagan of the University of Calgary, who has close ties to the current prime minister.

Yet few Canadians understand the special constitutional status of Canada's aboriginals, comprising Indians, Métis, and Inuit, partly because it is still not fully spelled out in the constitution. The Indians believe they should deal with Canada on a government-to-government basis, just as their ancestors did in the 1700s, when the British bought peace in the colony by signing treaties guaranteeing Indian rights to land and self-government. Those were incorporated in the Royal Proclamation of 1763 and again in Canada's new constitution. Paul Chartrand, a Métis member of a former royal commission on the aboriginals, says that Canadian governments are not interested in long-term solutions, seeking rather to “stamp out fires”. Mr Martin largely agrees: “This is a file that has been shoved under the rug for 150 years.”

The federal government spends an estimated C$9 billion ($8 billion) a year on aboriginal programmes, targeted mainly at the Indians living on 600-odd occupied reserves, where conditions are often dire. Last year the federal government had to evacuate the Kashechewan reserve in northern Ontario after its drinking water was found to be unsafe. The water quality in more than 200 other reserves has also been deemed risky. Although aboriginals living outside the reserves have lower levels of education, health and income than other Canadians, the gap is even wider for those on the reserves.

Meanwhile, disputes over land are frequent and often violent, the result of resurgent aboriginal nationalism and an awareness that the squeaky wheel gets the grease. Since 1990 some of the fiercest confrontations have been over an oil development near Lubicon Lake, Alberta, a golf course expansion at Oka, Quebec, a provincial park in Ipperwash, Ontario, a ski resort at Sun Peaks, British Columbia, and military flights over Labrador. Each has followed a depressingly similar course. Ownership is disputed. An aboriginal claim is filed and the federal claims-processing machinery grinds into motion. Years, often decades, go by without resolution. The fuse is lit when the contested activity is at last allowed to proceed, despite the outstanding claim. No matter which side eventually wins, the other regards it as an illegal occupation.

Not all the news is grim. On the land-claims front, there have been a number of cases where aboriginal insistence that their rights be recognised before industrial development proceeds has led to agreements on job creation, revenue-sharing, training and land ownership. This was the case with the Cree over the massive James Bay hydroelectric dams in northern Quebec, the Innu over the Voisey's Bay nickel mine in Labrador, the Inuit over diamond mines in the Northwest Territories, and the 1999 creation of the new territory of Nunavut, the largest land-claim settlement in Canadian history. Now aboriginal groups along the path of the proposed Mackenzie Valley natural-gas pipeline in the Northwest Territories stand to become part-owners of the C$7 billion project—if it goes ahead.

“Large-scale resource development has been the catalyst for just about every major land-claim settlement across the country,” notes David Natcher, professor of aboriginal studies at Memorial University in Newfoundland. The bigger the development, the better the chance at settlement, he says, because the companies put pressure on governments to reach a deal.

But smaller disputes, like the one in Caledonia, are much harder to solve. The present confrontation is happening a full decade after a royal commission presented the federal government with a supposedly clear roadmap on how to repair its deteriorating relations with the aboriginals. Set up by the Conservatives following the 1990 Oka conflict, the commission reported to a Liberal government in 1996. But the Liberals largely ignored its recommendations, including the suggestion that land claims be settled by a tribunal composed of both aboriginal and non-aboriginal members, rather than by the courts.

It is not too late for the new government to dust off that report. But even if all the aboriginals' claims are settled—and that seems unlikely given a backlog of more than 780 claims before the federal government—it would still not solve the aboriginals' plight. Some analysts argue for much more to be done for the two-thirds of aboriginals living within Canadian society. That might tempt more Indians to leave the wretchedness of the reserves. But this would require the two levels of government to stop buck-passing and get their act together. Although the federal government is supposedly responsible for the aboriginals' overall welfare, the provinces have jurisdiction over land and resources.

Is the new Conservative government ready to change decades of failed policies? Early signs are mixed. As a one-time member of a federal claims commission, Jim Prentice, the new minister of Indian and northern affairs, has wide experience of aboriginal affairs. He has already pledged to slash the backlog of claims and to do more for the off-reserve aboriginals. The government has also agreed to honour the promise of $2.2 billion by the previous government to compensate the victims of abuse in aboriginal residential schools. But other moves seem less promising: Mr Prentice has declined to intervene in Caledonia, refused to support a UN declaration on indigenous rights and reneged on the last government's pledge of an extra C$5 billion for social schemes.

As with so many federal issues in Canada, any real change in policy is unlikely until there is a majority government with the strength and will to ram it through. Meanwhile, private firms push ever further into remote areas in search of lumber, minerals, oil and gas, creating a whole new series of potential flashpoints.

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Argentina

The slow battle for justice

Sep 14th 2006 | BUENOS AIRES
From The Economist print edition

Pardons are lifted on three of the former junta's most senior members

THIRTY years after Argentina's army seized power and embarked on its horrific campaign of abductions, tortures and killings, the country is at last beginning to face down its demons. Last week federal judges overturned pardons granted to three leading members of the 1976-83 military dictatorship—Jorge Videla, the junta's first leader, Albano Harguindeguy, its interior minister, and Jose Martínez de Hoz, its economy minister—opening the way for their eventual trial.

The three were among nine junta leaders convicted and imprisoned for their part in a “dirty war” that resulted in at least 13,000 deaths and “disappearances”; human-rights groups put the toll closer to 30,000. But in 1989-90 all were pardoned by President Carlos Menem. The three men, whose pardons were ruled unconstitutional, may now be charged with the abduction of, and attempted extortion from a wealthy businessman, Federico Gutheim, and his son Miguel, who were held for five months in 1976-77 in an alleged attempt to force them to accept an export deal beneficial to the government.

Mr Videla is expected to appeal to the Supreme Court. He may not get much joy. Last year the court annulled a series of amnesty laws, passed in the 1980s, that shielded lower-level police and state security agents from prosecution for dirty-war crimes. Last month Julio Simón, a former police sergeant, became the first person connected with the junta to be sentenced since that ruling. He was imprisoned for a maximum 25 years after being convicted of kidnapping a disabled man, torturing him with electric shocks, and forcing him to perform sexual acts with other prisoners.

Around 200 former military officers are now facing dirty-war charges. But President Néstor Kirchner, who has sought to make human rights one of the trademarks of the current administration, is still not happy. “They say that there were more than 490 concentration camps and we barely have 200 people arrested. There must have been concentration camps where the prisoners looked after themselves!” he protests.

The prosecutions of the junta's torturers enjoy widespread support. But many on the right feel that justice is not being done even-handedly. They point out that while the 220 pardons granted to military officers are now being systematically revoked by the courts, there has been no effort to reopen the 57 files on former Montoneros, members of the leftist radical group whose terrorist campaign ravaged Argentina in the early 1970s, providing the pretext for the 1976 military coup. This may not be possible, however.

The Supreme Court ruled last year that a crime against humanity, which is not subject to a statute of limitations and can never be pardoned, must be committed by a government agent. Since the Montoneros did not form part of the state apparatus, the bombings and assassinations they committed are not considered crimes against humanity, and the statute of limitations on those offences has long expired. Though the Supreme Court's members are considered to be independent, a majority of them were named by Mr Kirchner, and some of his advisers have links to ex-Montoneros—notably Nilda Garré, the defence minister, whose ex-husband's brother reportedly set up the movement.

Mr Kirchner's somewhat laissez-faire attitude towards ordinary criminals may further open him to charges of hypocrisy. While he has consistently pushed for the harshest justice for the dictatorship's henchmen, he opposes tougher sentences as a crime-fighting tool in general. The burgeoning centre-right law-and-order movement in Buenos Aires is now using the president's own language against him. “Human rights aren't only for the past,” a speaker at a recent anti-crime rally protested. No one doubts the president's sincerity in pursuing Argentina's most deplorable criminals, but he may not welcome all the consequences of reopening the darkest chapter in his country's history.

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Chile

A difficult pill to swallow

Sep 14th 2006 | SANTIAGO
From The Economist print edition

A plan to tackle teenage pregnancies

IF CHILE'S health minister, Dr Soledad Barría, thought that making her announcement at a quiet Saturday session of a gynaecological conference would help the news to slip down more easily, she was wrong. For many in Latin America's most socially conservative country, the idea of their teenage daughters being able to nip round to their local health centre for emergency contraception—the morning-after pill—without their knowledge or consent, is too much for them to swallow.

“It's like telling them just to get on with it and have sex,” lamented one working-class mother. She has reason to be worried: 40% of sexually active 15-18-year-olds do not use any form of contraception, sex education is scanty, information on AIDS virtually non-existent, and condom-vending machines nowhere in sight. But the government of Michelle Bachelet, president since March and herself a paediatrician, points out that youngsters, many of them barely in their teens, are already having sex and that, not surprisingly, many of them are getting pregnant.

According to a 2003 survey, around 15% of all babies in Chile are born to teenage mothers. The proportion ranges from 22% in the poorest neighbourhood of Santiago to just 1% in the richest. The centre-left coalition, which has governed Chile since 1990, is partly to blame for that glaring difference. For several years now, the private health services, used by better-off Chileans, have been prescribing the morning-after pill to teenagers even without their parents' consent, while the national health service, catering for poorer Chileans, is still restricting its use to rape victims.

In defiance of the solidly Catholic Christian Democrat party, the ruling coalition's biggest partner, Ms Bachelet, who is herself an agnostic socialist, has now decided that the national health service should prescribe the morning-after pill to anyone over the age of 14, the legal age of consent, who wants it. In response to protests by horrified parents and opposition politicians, the Santiago Appeals Court issued a temporary injunction on September 13th banning the national health service from prescribing the pill to anyone aged under 19 without their parents' consent. But doctors argue that, if parents have a say, teenagers may be put off going to health clinics and end up seeking an illegal and risky backstreet abortion instead.

Dr Barría's announcement raised a predictable outcry among conservative opposition politicians and the Catholic Church. The plan “recalls the public policies of totalitarian regimes that wanted to impose state regulation on people's intimate lives,” thundered the Church. Ms Bachelet insisted that she was not seeking to impose her beliefs on anyone; she was merely offering alternatives.

And that, rather than easier access to contraception, is why so many young Chileans are jubilant. For them, the government's morning-after plan is one small sign that Chile's 16-year-old democracy may at last be mature enough to start offering greater personal choice and, they hope, greater tolerance of diversity. Many of their parents are wondering quite where it will all end. The legalisation of abortion? Gay marriage? Whatever next?

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Brazil

Crime of passion

Sep 14th 2006
From The Economist print edition

Murder most foul in São Paulo

WHATEVER the truth behind the murder of Ubiratan Guimarães in São Paulo last weekend, odds are it was a crime of passion. Colonel Ubiratan, who in 1992 put down a rebellion in São Paulo's Carandiru prison so savagely that 111 prisoners died, was a target of frequent death threats and never went out unarmed. Police believe his murder to be more likely the result of a lover's quarrel than delayed revenge. Nonetheless it has caused a bubbling debate over the rights of offenders vis-à-vis ordinary citizens to boil over.

In 2001 a judge sentenced Colonel Ubiratan to 632 years in prison for his role in the Carandiru bloodbath. But to many in São Paulo he was more hero than villain. The gregarious law-enforcer ran several times for the state legislature, choosing 111 as part of the code for supporters to punch into voting machines. Enough enjoyed the joke to elect him in 2002. A court overturned his conviction this year, saying that the judge had misinterpreted the jury's verdict (which several jurors denied). He was in the midst of a promising campaign for a second term when he was killed in his flat by a single shot to the abdomen. His girlfriend was questioned by the police.

If he had been shot gangland style—in the head—and his own revolver had not disappeared, suspicion might have fallen on the Primeiro Comando da Capital (PCC), a prison-based gang in São Paulo. It has a history of murdering law-enforcers in defence of its prison privileges, which include unfettered access to lawyers and mobile phones, used to transmit orders to operatives in the field. Last October, the director of Carandiru prison at the time of the 1992 massacre was murdered, allegedly by the PCC. In May the gang turned its fury on the entire state, particularly the capital. In one week it murdered some 40 policemen and burnt 80 buses, paralysing public transport. The police responded by killing more than 100 “suspects”. And the tit-for-tat violence continues.

Candidates in next month's general election are wooing the city's voters with vows to tackle crime. In such company, Colonel Ubiratan had nothing to prove. One mourner felt it was “a pity” that he had not killed a thousand prisoners. “Then you wouldn't have the PCC,” she reasoned. Among the more unlikely passions the colonel inspired was love.

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Japan

The man who remade Japan

Sep 14th 2006 | TOKYO
From The Economist print edition

But now Junichiro Koizumi is stepping down

AP

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THE 64-year-old who retires as Japan's prime minister on September 30th has earned a reputation as the reformer of the unreformable. During his tenure Japan's governing apparatus has been transformed, its economy has emerged from long years of degenerative decline, and its dealings with the world have been energised and emboldened. For all that, Junichiro Koizumi remains an enigma.

His triumphs derive from the wars he has waged against the ruling Liberal Democratic Party (LDP); yet, as the heir to a political dynasty, he built his career at the heart of that party. He used his personal popularity to trump the faction system that had hitherto controlled Japan's prime ministers; yet for all his charm he is a loner, dining for preference by himself. He has yearned to raise Japan's standing in the world; yet he has persisted in making annual visits to the Yasukuni shrine where the souls of Japan's war dead are venerated, and that has destroyed much of Japan's standing with its neighbours.

When Mr Koizumi won the party presidency, and thus the prime ministership, in April 2001, the LDP had ruled for all but 11 months of the previous 46 years. Or, rather, it had shared power with the heads of big business and the bureaucrats at the main ministries. This “iron triangle” had cosseted business, channelling money into industries that, as part of the bargain, guaranteed a lifetime's work and a comfortable retirement for their employees. And Japan thrived. Indeed, in the four decades after the second world war it was the world's greatest success story.

But the success was not everlasting. By the time Mr Koizumi came to office, scandals, corruption and a lack of accountability had thoroughly discredited a system hijacked by interest-groups, the LDP prominent among them. Factions within the party were vehicles for political patronage, and they had enfeebled successive governments, most of them led by antique prime ministers who would serve a brief and ineffectual term. The system had proved incapable of dealing with the slump that followed the property and stockmarket collapse of 1990, leaving Japan's banks with piles of bad loans.

Successive governments had responded by ramping up the spending on public works. That may have

staved off a more vicious deflation, but the spending was adding alarmingly to the country's public debt, just as Japan's population was starting to shrink, and so too its tax revenues. Making matters worse, the public-works spending that was smothering the country in concrete merely reinforced the unsavoury links between the LDP's hacks and their supporters in the construction industries. At the same time it entrenched the powers of the bureaucracy, making change even harder.

The system's inadequacy at home was matched by a feebleness abroad. After Japan's defeat in the second world war, America foisted on it a pacifist constitution that limited its forces to the role of self-defence and forbade it to send them abroad. Though the definition of “self-defence” had been gradually stretched, Japan seemed unable to shoulder international responsibilities except through its generous aid budget, or even to protect its own direct interests.

All in all, Japan was in a sorry state in 2001. The post-war success story had become a wretched tale featuring a “lost decade” for the economy, years of falling prices, insolvent banks, corrupt politics at home, disrespect and ingratitude abroad.

Enter the Lionheart

Bidding for the party leadership in 2001, Mr Koizumi came with a reputation for pushing change. He was a critic of the faction system, and obsessed with the need to break up the post-office savings system. But he faced Ryutaro Hashimoto, who had served once already as prime minister and who headed the LDP's most powerful and conservative faction. Mr Hashimoto looked a shoo-in.

Mr Koizumi whipped him, however, by using a mastery of television and the popular press to make a direct appeal to the grassroots. It had never happened before. The elders abhorred Mr Koizumi's calls for painful change (“Reform with no sacred cows”) and his attacks upon the party (“Change the LDP, change Japan”). His directness, his wavy-maned flamboyance and his use of the modern media seemed like a running insult to their way of doing things. Soon, though, it was clear that the Koizumi phenomenon was also good for the party. In the elections for the upper house in July 2001, the LDP had its best result in a decade.

By Japan's standards, the prime minister's agenda was radical. Within the government, cabinet posts were to be allocated by merit and no longer by faction. Spending on public works was to be slashed, and government borrowing capped. The highway corporation, a great source of pork-barrel spending, was to be broken up. Local governments were to be given more power, but also more responsibility. As for the banks, they would have to acknowledge the full extent of their bad loans and then sort them out to get the economy going again.

Above all, Mr Koizumi was going to privatise Japan Post. This ambition—once shared by his grandfather, who had been postal minister—may seem curious. Yet as well as delivering the mail, Japan's postal system is also the world's biggest bank, with ¥320 trillion ($2.8 trillion) in savings and life-insurance accounts funnelled towards favoured public-works projects and a collection of public financial bodies and their clients. Like the highway agency, it lay at the heart of the dismal relationship between Japan's politicians, bureaucrats and interest-groups. To break it up would do much for the distortions running through the economy. The public to whom Mr Koizumi appealed seemed to understand his mission.

From the start, though, Mr Koizumi met resistance. The road-building lobby and backers within the LDP stymied change, restoring highway projects that had been axed. Attempts to privatise the postal system fared no better. Worse, too little was being done about the banks' bad loans, and the stockmarket was becoming alarmed. The further the stockmarket fell, the greater the threat of insolvency to the banks, which treated the value of their shareholdings as capital. As a sense of crisis grew in 2001-02, Mr Koizumi looked like yet another in the line of leaders who had delivered little.

A change in fortune came in 2003. That year Heizo Takenaka, an economist brought in by Mr Koizumi to mastermind domestic reforms, made progress with the banks. He toughened their supervision and forced them and their regulators to face up to their parlous state. At last, a vehicle was created to take on banks' bad loans. The stockmarket turned.

In the autumn of 2003 Mr Koizumi crushed a challenge to his party leadership and won a general election handsomely enough, despite the revival of the opposition Democratic Party of Japan (DPJ). A new cabinet appeared to give a sense of purpose. Much of Mr Koizumi's first cabinet had been inherited. However, his second was of his own making. Out went the 81-year-old finance minister and in came a number of

young reformists, such as Nobuteru Ishihara, who took charge of the notorious land and transport ministry. Shinzo Abe, an ally, was made the party's secretary-general.

A brighter economy

The recovery that had begun tentatively in 2002 looked more assured as firms began investing again. As companies' profits revived, the banks' bad loans began to fall. Having stood at over 8% of GDP at their nadir in March 2002, they are under 2% today—a drop, says Mr Takenaka, that he had expected to take ten years. The biggest banks have repaid public money. They are starting once more to provide credit to the economy and thus lay the foundation for future growth. It is one of the main accomplishments of the Koizumi era.

In other endeavours, though, Mr Koizumi's government struggled. Hardened operators quickly outmanoeuvred the neophytes brought in to push through privatisation—Naoki Inose, a writer, for the highway corporation, and Mr Takenaka for the post office. Bold proposals were diluted. Though agreement was reached for the highway agency to be split into six, it was to remain in public ownership. As for Japan Post, rather than abolishing its savings and insurance functions altogether, they would continue as separate operations, and privatisation would be deferred to 2017. And despite these large concessions, in August 2005, after a nasty fight, the parliament's upper house narrowly voted the postal plan down.

It was a defining moment, one that Mr Koizumi greeted with relish. He called a snap general election. The DPJ was on the run: though reformist, it had chosen—disastrously as it turned out—to oppose postal privatisation on tactical grounds. But the election was a challenge to the old guard in the LDP too. Mr Koizumi expelled 37 lower-house rebels who had voted against privatisation, and put up allies to run against them. The fight, he told the country, was about a single issue of reform: privatising the post office. The two-thirds majority returned for the LDP and its ruling coalition vindicated him.

His authority now unchallenged, the postal and highway bills quickly sailed through the new parliament. Even if the post office is not yet privatised, says Yasuhisa Shiozaki, a deputy foreign minister and rising star, Mr Koizumi has at a stroke destroyed the country's most powerful political machine, and put an end to pork-barrel politics. He also moved to “normalise” foreign and security policy, challenging the limits placed on Japan by its post-war pacifist constitution by sending refuelling tankers to the Indian Ocean and troops to Iraq. He riled China and South Korea by visiting Tokyo's Yasukuni shrine, where among the millions of Japanese war dead who are commemorated are the souls of a number of war criminals.

Yet a new enigma emerged. Although the election had put reform at the centre of politics, and although Mr Koizumi was at the top of his form, he swiftly lost interest in fresh fights, say his colleagues. Early this year the committee he had put in charge of road reform voted to build 9,000km (5,600 miles) of expressways that had first been proposed in the late 1990s. The total cost to the taxpayer will be ¥3 trillion. But barely a squeak came from the prime minister.

Mr Koizumi must step down as party president this month, and so as prime minister. He could, if he chose, exert influence behind the scenes, yet recent behaviour suggests that he will not. Mr Koizumi spent much of the summer on swansong trips abroad, including one to Graceland, with President George Bush. Mr Koizumi says he intends to devote himself to music and the pleasures of the table—not to mention a private life again—and there is every reason to believe him.

The king is dead, long live the king

So will Mr Koizumi's reforming zeal outlast him? It is a mark of change that his successor is presumed to be Shinzo Abe, a man of only 51 years. He is likely to prevail as the next leader of the LDP in the vote on September 20th. Now chief cabinet secretary, he is a Koizumi protégé. Most of his main allies—Hidenao Nakagawa, head of the party's policy-research council, Mr Shiozaki, Mr Ishihara, Taro Aso, the foreign minister, and Kaoru Yosano, the economy minister—have played reforming parts during the Koizumi era.

Mr Abe says he is committed to further deregulation to promote growth. But some foresee a difficulty. Though telegenic, Mr Abe lacks Mr Koizumi's charisma and authority. He will need co-operation within the party to build a governing consensus, or else risk a party revolt. From the outside, says Gerald Curtis, of America's Columbia University, the procedure will look a lot like the backroom politicking that the voters

now abhor. It makes reform uncertain.

A brighter view is possible, one that sets Mr Koizumi's reforms in the context of other changes that have been made to the way Japan is governed. The abolition of multi-member constituencies in the mid-1990s and the introduction of public financing of political parties have, for instance, hastened the decline of money politics and factions. Mr Abe himself is leaving his faction, as Mr Koizumi did—an inconceivable move when faction bosses were kingmakers not long ago.

Another change is the way authority has accrued to the prime minister's office within government, and to the secretary-general within the ruling party, a position now in the gift of the prime minister. It means, first, that political advancement hangs more on showing loyalty to the leadership than to your faction. Crucially, it encourages party and government to agree on policy. For example, agreement was reached in July on a fiscal blueprint that is meant to set the country's finances to rights. The plan envisages swingeing spending cuts of up to ¥13 trillion a year by 2011. “No matter what,” says Mr Nakagawa, the powerful head of the policy-research council, “we're going to incorporate that July decision in every budget.” Mr Nakagawa insists that reform now flows rudely through the party's veins.

As for foreign policy, Mr Abe's backers say that the new confidence fostered by Mr Koizumi is here to stay, and that Mr Abe will make a better fist of explaining it to Japan's neighbours. Mr Abe, though like Mr Koizumi a regular visitor to the Yasukuni shrine, and an advocate of a stronger national security, nonetheless appears to think about foreign policy in a more rational way than the strangely emotional Mr Koizumi. Mr Shiozaki says that Mr Abe knows that going to Yasukuni as Mr Koizumi has done would only deepen the mess with Japan's neighbours. This past weekend Japan's deputy foreign minister has been in the capitals of South Korea and China, part of a sudden flurry of diplomatic activity among the three countries. Takao Toshikawa, editor of *Tokyo Insideline*, a newsletter, predicts that Mr Abe, immediately after becoming prime minister, will break the ice with a visit to Beijing to meet President Hu Jintao.

Mr Abe, carrying forward the Koizumi revolution, may yet prove short-lived as prime minister. He would, for instance, be unlikely to survive an LDP defeat in next July's upper-house elections, which already causes the party concern. Yet if the DPJ won, it would be on a reform ticket: the opposition will not repeat the mistake of opposing change. In other words, even in an LDP defeat, Mr Koizumi's useful legacy will still be discerned.

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India and Pakistan

Unhappy holidays

Sep 14th 2006 | DELHI
From The Economist print edition

A frosty weekend in Havana

COUNTRIES cannot choose their neighbours, Manmohan Singh, India's prime minister, told the press on September 12th, but India and Pakistan have to talk to each other because their destinies are linked. Those downbeat words suggested a distinct lack of optimism as Mr Singh prepared for a meeting with President Musharraf of Pakistan, planned for this weekend in the margins of a Non-Aligned Movement conference in Havana. It will be the two leaders' first encounter for a year and the timing is not propitious. It comes just a week after bomb blasts killed more than 30 people at Malegaon in the Indian state of Maharashtra.

Mr Singh will reiterate India's belief that Pakistan is at least partly to blame for such blasts because it has failed to prevent (and many Indians believe it encourages) terrorists to cross into India. He will also give warning that Indian public opinion will not allow him to continue talking at all if the attacks do not stop. For his part, President Musharraf has said that he will be urging India to make concessions on the two countries' central quarrel over the disputed territory of Kashmir.

Both men know however that neither can deliver in the foreseeable future on either score. The limited aim, instead, is to ease tensions by agreeing to resume regular talks between the country's top diplomats. Those talks were shelved after more than 180 people were killed in July by a series of explosions on busy commuter trains in Mumbai. Meanwhile, Mr Singh is expected to give up direct responsibility for the India-Pakistan relationship next week, when he plans to appoint a new foreign minister to take over the portfolio that he has held for ten months.

India blamed the Pakistan-supported Islamic Lashkar-e-Toiba for the Mumbai train blasts, but it was Muslims who were targeted at Malegaon, which has a long history of Hindu-Muslim tension. That led to suggestions that Hindu extremists might have been involved, though local police insist that the kind of explosives used point to Islamic groups. It is unlikely that much more will be discovered. India proceeds slowly with investigations and prosecutions on such cases. On September 12th four men were convicted by a Mumbai court for plotting explosions that killed 257 people in the city 13 years ago. Verdicts are still pending in a further 116 cases.

One of the reasons for a lack of progress is that Indian security forces often kill suspected terrorists

rather than arresting them. This is frequently criticised both by counter-terror experts (because sources of information are lost) and by human-rights organisations. A new report on the Kashmir conflict by Human Rights Watch accuses India of summarily executing militants and reporting the deaths as the result of clashes with the army.

It said immunity given to troops in Kashmir encouraged them to commit abuses. The report also criticised militants for attacking civilians and noted that groups like Lashkar-e-Toiba, banned after the September 11th 2001 attacks, have been allowed to change their names and continue operating—exactly what Mr Singh will be telling Mr Musharraf. It is unlikely to be a joyous weekend break.

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Thailand

Inching towards a new election

Sep 14th 2006 | BANGKOK
From The Economist print edition

But will the prime minister survive?

Get article background

AT LONG last a smidgen of good news from the slow-motion train crash that Thailand's democracy has come to resemble. On September 8th, amazingly, the Senate approved a new set of election commissioners—sooner and with less fuss than many had expected, given the shenanigans that have left this country bereft of a parliament for seven months.

New commissioners were needed because three of those who had overseen February's election, which the opposition boycotted and the courts later annulled, were sent to jail for botching it. A spokesman for Thaksin Shinawatra, the prime minister, said that the choice of a new commission showed that the situation was improving, and that a fresh election could be held soon. But this week the election was again postponed from its planned date of October 15th. With luck, it may be delayed only a month or so. Equally, it could be knocked into next year.

Whenever it is held, Mr Thaksin's Thai Rak Thai (TRT) party looks likely to win another majority, despite the accusations of corruption and abuse of power that have been laid against its leader. But will Mr Thaksin continue as prime minister? That could well provoke a return of demonstrations demanding his downfall.

Mr Thaksin has not yet disclosed his intentions even to his cabinet. Several of them would like him to win the election for them—he remains popular among poorer, rural voters—but then bow out in favour of a less divisive figure. This week one investment firm put the chances of Mr Thaksin staying on at less than 50%.

His quiet departure after a fresh election might indeed be best for Thailand. But for the present, and while he keeps everyone guessing, the country is on edge. There have been disquieting rumours of plots to overthrow or even assassinate the prime minister. In late August police arrested a junior army officer in a car packed with explosives, near Mr Thaksin's home.

His critics accuse Mr Thaksin of staging the bomb plot in order to win sympathy from voters. They are also reporting rising unrest in the army over his attempts to secure promotion for his chums in the annual shuffle of military commanders. According to one popular theory, these moves are part of a power struggle between Mr Thaksin and a rival group led by Prem Tinsulanonda, a retired general who is King Bhumibol's senior adviser. If true, the consequences could be nasty.

Mr Thaksin is apparently unfazed by the conspiracy theories. He has left the country on a long foreign trip. But even if those theories are a nonsense, several legal cases now under way could also cause political or economic conniptions.

First, the Constitutional Court is considering whether to disband both TRT and the Democrats, the other main party, over their conduct in April's election. Second, of various investigations into Mr Thaksin's sale in January of his family's telecoms business, one is looking at whether the main buyer, Singapore's Temasek, exceeded legal limits on foreign ownership. If so, many other foreign investors could be at risk. A third big legal argument is raging around whether the part-privatisation of the state oil firm, PTT, was illegal and should be reversed. So far, both the currency and the stockmarket remain fairly steady. For how long?

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Australia and Indonesia

In mortal danger

Sep 14th 2006 | SYDNEY
From The Economist print edition

Relations between the neighbours keep getting worse

Reuters

WHEN a group of young Australian drug smugglers known as the Bali Nine were sentenced in February, two received the death penalty. Most of the others appealed against their life prison sentences, hoping for more lenient ones. Instead, the Indonesian Supreme Court recently replaced four of those sentences with death, bringing to six the number of Australians on death row in Indonesia. The decision has strained a relationship between the Pacific neighbours that has been difficult at the best of times. It has also renewed charges in the region against Australia of holding double standards.

The Bali Nine, eight men and one woman, aged between 19 and 30, were arrested in the Indonesian resort in April last year trying to smuggle eight kilograms of heroin to Australia. Graphic images of police parading some of the “mules” with bags of heroin taped to their bodies gave their story sensational coverage back home. At first public sympathy for their plight was more muted than it had been for Schapelle Corby, a comely 27-year-old who was arrested in Indonesia in 2004 and convicted of smuggling marijuana into Bali. But the latest harsh sentences have aroused Australians' indignation.

For the conservative coalition government of John Howard, the Australians in Bali's prisons pose a political and diplomatic dilemma. Mr Howard has recently endured the humiliation of seeing his attempt to repair relations with Indonesia on another front backfire. Indonesia temporarily withdrew its ambassador in March in protest at Australia's acceptance of 42 asylum-seekers from Papua, a province of Indonesia with a long-standing separatist movement. Mr Howard responded by introducing legislation that would have sent future boat people to Nauru for processing, a move his critics called appeasement of Indonesia. He was forced to withdraw it in August after several members of his own government threatened to vote it down in parliament.

Mr Howard boasts of his strong relationship with Susilo Bambang Yudhoyono, Indonesia's president, who takes a hard stand against drug-trafficking. Yet the Bali Nine's case raises questions about how close the relationship really is. Mr Howard, his government and the Bali Nine themselves learned of the Supreme Court's recent imposition of four more death sentences not from the Indonesian authorities but from Australian newspapers. Indonesian officials have since confirmed it; so far, the court has given no reason for its decision.

Australian ministers say they will lobby their Indonesian counterparts for clemency for the six Australians who now face the firing squad. Here again Australia is on shaky ground. It officially opposes capital punishment. But Mr Howard, always with an ear to the thoughts of suburban voters, has been selective in his opposition. Like a majority of Australians, he opposed the sentence on an Australian who was hanged in Singapore for drug-trafficking in 2005. But he said he would not oppose the death penalty for perpetrators of the 2002 Bali bombing, which killed 202 people including 88 Australians.

Michael Fullilove, of the Lowy Institute, a think-tank in Sydney, says that Australia's “perceived hypocrisy” on the issue has damaged its regional relations, and makes it harder for its pleading on behalf of those such as the Bali Nine to carry weight. He says Australia should form a coalition with the four Asian countries that have abolished the death penalty in the past decade and nudge Indonesia and others to do the same. For the Bali Nine, any nudging may come too late.

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Poverty in Indonesia

Always with them

Sep 14th 2006 | JAKARTA
From The Economist print edition

The Indonesian economy is growing. But so, unfortunately, is poverty

WHEN two scavengers died last week under a landslide at Jakarta's main rubbish dump, the extensive television coverage that resulted provided a too-rare glimpse into the plight of some of Indonesia's poorest people. And their ranks are swelling. After declining for six years the number of poor people has increased sharply. Some 39m, 18% of the population of 220m, are now officially poor, according to data just released by the government's statistics bureau, 4m more than in 2005.

AFP

Almost one in five

That the poverty level has stopped falling is no surprise. A 126% increase in fuel prices last October catapulted inflation to 18%, while wages increased only marginally. The number of poor Indonesians would have soared even more, to 51m according to the statistics office, if the government had not given cash handouts to some 76m people to cushion the effects of the fuel-price increase (which eliminated a costly subsidy). But activists are questioning the data. They argue that the figures fail to give the full alarming picture.

The Urban Poor Consortium believes, for example, that the number of people falling into poverty in Jakarta has risen by almost twice as much as the statisticians state. It also says that more people are, relatively speaking, even poorer than they were a year ago. Numerous academics echo their claims. This is partly because the government's definition of poverty—less money than is needed to afford a diet of 2,100 calories a day—is 152,847 rupiah ($16.80) a month. This measure is well below the more widely used benchmark of $1 a day. Using the $1-a-day measure, it is estimated that more than 80m Indonesians are in poverty.

Government officials admit their target, a poverty level of 8.2% by 2009, is anyway unattainable. The current economic growth rate of around 5% is insufficient to provide all new job-seekers with employment, let alone dent Indonesia's huge unemployment tally. Ministers did announce earlier this month an extra $1.4 billion for poverty alleviation in 2007, 18% up on 2006. This will be distributed through a community-empowerment programme, under which each village will be given up to $110,000 more than this year to create jobs in the way it deems best. The goal is 15m additional jobs within three years, with 12.5m of them coming through the village schemes and the rest from the development of the plantation industry.

Admirable though it is, this policy does not tackle the root cause of Indonesia's rising poverty. A report on the subject being prepared by the World Bank argues that artificially high rice prices are much more to blame than the effects of the fuel-price increase. This is because most poor people spend a quarter of their earnings on rice, which has risen in price by more than a third in the past year. Keeping domestic

rice prices higher than international prices by severely limiting imports makes little sense, the World Bank argues. It claims that 75% of the poor earn their living from agriculture but that at least 75% of the poor are net rice consumers.

Even if rice prices were to plummet, other brakes on poverty alleviation remain. The government's unconditional cash handouts are scheduled to end in the third quarter of this year. Their complicated replacement, payments conditional on children remaining in education and meeting health targets, is unlikely to be ready till the middle of next year. Promised spending on infrastructure should pull some people out of poverty. But few government policies suggest that the national average education of less than seven years' schooling, a prime cause of poverty, will rise soon. For many Indonesians, the future remains pretty bleak.

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Lebanon after the war

Hizbullah's new offensive

Sep 14th 2006 | BEIRUT
From The Economist print edition

Reuters

With politics and clearing-up at full tilt, Lebanon is struggling back to normality—except that Hizbullah is more prominent than ever

THE bombs have stopped falling, but politics remains a noisy business in Lebanon. During the 33 days of fighting between Israel and Hizbullah's guerrillas, a shaky ceasefire prevailed among Lebanon's fractious factions. But in the month since a UN-imposed halt to war, the volume and nastiness of rhetoric between Lebanese politicians has risen inexorably.

Hizbullah officials openly accuse the government of collaborating with Israel, and with its Western backers, to “destroy the resistance” and thereby expose Lebanon to further Israeli attacks. General Michel Aoun, whose centrist Christian party, the Free Patriotic Movement, is tactically allied with Hizbullah, derides the government as a mafia, a kleptocracy that clings to power out of its greed to pocket the postwar influx of foreign aid.

For its part, the ruling coalition, a grouping of Sunni Muslim, right-wing Christian and Druze parties and liberal independents that is widely referred to as the “March 14th movement”, blames Hizbullah for having started a war that killed 1,200 Lebanese, scorched dozens of villages and shattered much of the country's infrastructure. Rather than deterring Israel, said a March 14th statement, the Shia party's weapons had turned Lebanon into “a battleground used by Iran to improve its bargaining position with the international community and by the Syrian regime to exercise its hegemony over Lebanon.” As for Mr Aoun, some March 14th members privately say that his backing for Hizbullah gave the Shia party political cover for its reckless behaviour in triggering war.

The fiery tone of such broadsides might suggest that the more important ceasefire, the one with Israel, which requires strong commitments from the Lebanese state, was in danger of imminent collapse. In fact, UN Security Council Resolution 1701, the deal that stopped military hostilities, has proved increasingly effective. The UN's secretary-general, Kofi Annan, this week reported “significant progress”.

Despite minor incidents and violations by both sides, says Mr Annan, the crucial part, a simultaneous pullout of Israeli forces from southern Lebanon and the deployment of both the Lebanese army and international peacekeepers, has proceeded apace. With more than a dozen countries having pledged troops, the size of the international force will soon reach 5,000 men, the comfort level Israel has said it

wants before full withdrawal. By February the number of peacekeepers could reach its target level of 15,000. Already the multinational flotilla patrolling Lebanon's shoreline is one of the largest ever assembled in peacetime.

Mr Annan reports movement on other issues, too. He has appointed a secret mediator to negotiate a prisoner swap between the sides, and says he will address Lebanon's claim to the Shebaa Farms, a patch of land within the Israeli-occupied Golan Heights that Israel has hinted it might be willing to cede in the interest of a more permanent settlement.

With the lifting of Israel's crippling blockade and the arrival of a torrent of international aid, Lebanon's battered economy is beginning to recover. Roads and bridges have been patched enough to ease traffic through most of the country. Emergency generators, many sent by Iran, as well as temporary water tanks set up by foreign donor agencies, local charities and Hizbullah, provide basic services to southern villages. Massive quantities of rubble have already been cleared from such devastated areas as Beirut's southern suburbs.

In Nabatiyeh, a large Shia market town, neatly bulldozed lots now mark the site of two wrecked five-storey buildings in the central souk. Local shopkeepers praise Hizbullah for keeping their goods safe during the fighting, when most people sought refuge in the north. Within a fortnight of the ceasefire, says Qasim Hussein, an upholsterer, the party had fitted a shiny new metal shutter onto his damaged workshop. A team sent to assess his losses promised a new sewing machine and cash to compensate for burnt fabrics.

Yet the task remains enormous. The cost of direct structural damage from the war has been estimated at $3.6 billion. The destruction of personal belongings, plus indirect losses incurred by such things as factory closures, higher insurance premiums and reduced tourist revenue, amounts to perhaps three times as much. In all, the cost is about equal to half Lebanon's GDP. In the south Israel's scattering of hundreds of thousands of unexploded cluster bomblets has hampered reconstruction, as well as farmers' access to their fields. This deadly ordnance has killed 12 people since the conflict ended.

Across Lebanon some 130,000 people lost their homes. Al Khiyam, for instance, is a hilltop village of 30,000 people that was heavily shelled, though never occupied by Israeli troops. Its mayor, Ali Zureiq, a proud Hizbullah supporter, estimates that 1,000 out of 4,800 houses, as well as four of its five schools, were totally destroyed. A further 3,000 residences were badly damaged. In his office Mr Zureiq sits besieged by villagers patiently waiting for him to scribble chits that will allow them Hizbullah compensation. All will be served, he insists, vowing that the party will also rebuild all the schools as well as two demolished mosques and two churches.

The right to call the shots

The speed, efficiency and propaganda savvy of Hizbullah's reconstruction offensive have caught Lebanon's flimsy government off the mark, and helped bolster the party's popularity beyond its core Shia supporters. It was already riding high. Many Lebanese are persuaded that Hizbullah's guerrillas, by holding a far more powerful Israel at bay, have earned the right to call the shots in the country's future. Backing for the party remains strong from Iran and Syria, as well as from Islamist opinion across the region.

But some $1 billion pledged in aid is likely to flow through other channels. With Hizbullah's rivals in Lebanon, including dissident Shias determined to outbid the party in the aid game, many Lebanese predict that Hizbullah will sooner or later have to tone down its militancy.

In strictly military terms, the party's potential has already diminished. Israel believes its air strikes succeeded in taking out most of the group's longer-range rockets. With foreign fleets offshore, and the Lebanese army now patrolling the Syrian border, replacing them will not be easy. The recent seizure, by Cyprus, of a Syria-bound cargo of North Korean air-defence gear underlined this point. The insertion of a robust international force in the south, meanwhile, makes it unlikely that Hizbullah will be able to reactivate its frontline forces with anything like the effectiveness they used to enjoy, even if they are not forced to surrender their arms.

This, of course, remains the most contentious issue. “After the defeat of Israel's army there is not another army in the world that would dare take one step towards disarming Hizbullah,” declares Nabil Kaouk, the party's commander in the south. But the UN Security Council demands the disarming of “all

Lebanese militias". In the past Lebanese governments wary of the gunmen fudged the issue by saying Hizbullah was not a militia, but a "resistance force". The current government knows it can no longer get away with such sleight-of-hand.

Although some, Israelis especially, want to see the issue forced, the main enforcers on the ground, the UN and the European Union, understand that this would not be good for Lebanon. Consequently, Mr Annan urged the speeding of a "political process to define a time-line for Hizbullah's full disarmament through dialogue". Despite the charged exchanges in Lebanon, this might just be possible. Much of Hizbullah's armed strength consists of local village militias, which could be incorporated into a national gendarmerie. The rockets would go to the army.

Ultimately, the only guarantor for a solid peace is a wider regional deal that would pacify or neutralise Hizbullah's patrons. "Other crises cannot be ignored, especially in the occupied Palestinian territory, as they are all interlinked," said Mr Annan. "Until the international community insists on a just, lasting and comprehensive peace in the Middle East, any one of these conflicts has the potential to erupt and engulf the entire region."

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Palestine

National unity, at long last

Sep 14th 2006 | JERUSALEM
From The Economist print edition

But will this end the world's siege of the Palestinian Authority?

Reuters

Haniyeh (left) leading Abbas somewhere

A STEP towards peace talks, or just a new holding pattern? It is a little early to say. This week's decision to form a unity government between Hamas, which runs the Palestinian Authority (PA), and Fatah, which used to, looks promising. The official policy of the new government, which will probably continue to be led by Ismail Haniyeh, a Hamas man, will be based on the proposal adopted in 2002 by all the Arab League states. This was to normalise relations with Israel so long as Israel meets certain conditions, including giving up the territory it occupied in the 1967 war.

Until now Hamas has said only that it would accept a Palestinian state on the pre-1967 borders and a long-term truce with Israel; it has not renounced its claim to all the rest of Palestine or promised a final end to the conflict (though it does say that it would put the question of full peace to a Palestinian referendum). Adopting the Arab League proposal is therefore a genuine, if small, step forward. Hamas hopes this will persuade the world to ease the crippling economic embargo that it imposed on the PA when Hamas took power in March. A recent poll by Nablus's al-Najah University found that nearly two-thirds of Palestinians think so too.

However, Hamas's move does not meet the three conditions presented last January by the Quartet (the UN, the EU, America and Russia), which called on Hamas to recognise Israel, end violence and honour the existing agreements between the PA and Israel. And Hamas says that the new policy is that of the government alone, not of the party itself. Predictably, therefore, Israel has dismissed the news of the unity government as insignificant.

Even so, there may be a crack of hope for the renewal of aid. When Tony Blair, Britain's prime minister, visited Mahmoud Abbas, the Palestinian president, two days before the coalition was announced, he said that “such a government, based on the Quartet requirements, does offer the possibility of re-engagement by the international community...and if such a government is formed, then I believe it is right that the international community deal with such a government.” His triple mention of the phrase “such a government” suggests that if the government accepts the Quartet conditions, even if Hamas does not, the PA might be allowed out of its isolation.

Mark Regev, an Israeli foreign-ministry spokesman, said that Israel is “dealing with the government and we'll see what the government does. If it accepts the three benchmarks and releases Gilad Shalit [the soldier captured in June by Palestinian militants] that will be a very positive step.”

But could Hamas make this concession? Its stubborn line has, up to now, played well to Palestinian suspicions of Israel's intentions. “To date, Israel has not recognised the 1967 lines as its legal border,” Ahmad Yousuf, a Hamas spokesman, told an Israeli newspaper. “When it does so, I will tell you whether we recognise Israel.” It is a common Palestinian belief that the three Quartet conditions are designed not to encourage Hamas to change its stance, but to provide an excuse never to have to deal with it. Indeed, for Palestinians, the main purpose of a unity government has always been to reduce the factional infighting that has rendered the West Bank and Gaza ungovernable, rather than as a sop to Israeli demands.

Conversely, among Israeli Jews, the distrust of Hamas is almost universal. Even Zehava Gal-On, arguably

Israel's most left-wing Jewish parliamentarian, says she would find it very hard to talk to the group, though she acknowledges that it will eventually become inevitable.

Yet both the Palestinian and the Israeli leaderships are under growing pressure to find a new course. Hamas has been facing massive strikes by PA workers, in despair after months without wages; the al-Najah poll gave Fatah nearly twice as many votes as Hamas if a new parliamentary election were held. The Israeli government led by Ehud Olmert is scrabbling for a toe-hold after the failure of its campaign against Hizbullah in Lebanon. Even before that war, Mr Olmert had said he would negotiate with a Hamas-led government if it accepted the Quartet's conditions.

The day after the Palestinian unity government was announced an Israeli military court ordered the release of 18 Hamas legislators and ministers arrested in recent weeks. That could become the first step in an exchange of Palestinian prisoners for Corporal Shalit. Both Israel and Hamas have said that they are ready for talks between Mr Olmert and Mr Abbas. But everybody knows that the Palestinian president is powerless to implement anything on his own. Unless the new PA government adopts the Quartet's conditions, says Mr Regev, a meeting between the two men will be “just a meeting”. Still, perhaps it would be a start.

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Iran and Israel

Milking the Holocaust

Sep 14th 2006 | TEHRAN
From The Economist print edition

Mahmoud Ahmadinejad's revisionism is aimed at the wider Islamic world

AFP

Get article background

No

IRAN'S growing political incorrectness thrills and scandalises the two worlds: Islamic and Western. The country's combustible president, Mahmoud Ahmadinejad, launches blistering verbal attacks on Israel. An exhibition of more than 200 satirical cartoons about the Holocaust, on show in a state-owned museum in Tehran, is about to come to its underwhelming end. Behind both lies a tale of domestic vulnerability and foreign ambition.

The old Middle Eastern view that the world's Jews exaggerated the Holocaust to rationalise Israel's formation and subsequent brutalities against the Palestinians has long underlain the Islamic Republic's hostility to Israel's presence in the region. But it took Mr Ahmadinejad, and his now notorious description of the Holocaust as a “myth”, to reheat the issue.

Prompted by the publication in Europe of caricatures lampooning the Prophet Muhammad and the defence, by some Western editors and politicians, of these caricatures on grounds of freedom of speech, came the idea of demolishing a Western shibboleth in retaliation. The idea, say the organisers of the Holocaust exhibition, is to highlight Western double standards when it comes to freedom of speech. Mr Ahmadinejad has queried the fitness of such countries as Germany, Austria and France, where Holocaust-denial is a crime, to lecture Iran on free expression. The trouble is that only a few of the works in the show confine themselves to probing this inconsistency.

Dozens of the cartoons, the Iranian entries in particular (entries came from countries as diverse as Italy, Brazil and India), are wantonly anti-Semitic. The imagery is grotesque and predictable: Stars of David morphing into swastikas; the Statue of Liberty giving a Nazi salute. Subtle, the cartoons are not. Perhaps for this reason, visitor numbers have been on the low side. Your correspondent had the place to himself, until more foreign journalists turned up. That may not matter to Mr Ahmadinejad: the suspicion is that the show, like his outrageous one-liners, is aimed abroad.

This became clear from the president's decision, at the end of August, to release the text of a long, quixotic letter that he had sent to the German chancellor, Angela Merkel. In this letter Mr Ahmadinejad regretted that the victors of the second world war continue to keep “a black cloud of humiliation and shame” hanging over modern Germans, described Israel as “the greatest enemy of humanity” and urged Ms Merkel to join Iran in an alliance to set the world to rights. She did not reply.

Her silence exemplifies Westerners' bewilderment and distaste at the revisionism of a leader whose country was a bit player in the war and does not even border Israel. On September 3rd Kofi Annan, the UN's secretary-general, observed during a visit to Tehran that the Holocaust is “an undeniable historical fact”. On the same day the Iranian government announced its intention to hold a conference on the subject in Tehran. “Scholars” who refute the conventional history of the Holocaust will no doubt feature prominently.

For a president whose influence over strategic decisions, especially in foreign affairs, is constrained by the untrammelled power of Iran's supreme leader, Ayatollah Ali Khamenei, probing the Holocaust is a

cheap way of raising his prestige among Islamists everywhere. But it seems that for Mr Ahmadinejad, too, freedom of speech has its limits. On September 11th the government banned Iran's foremost reformist newspaper, *Shargh*, for publishing a cartoon that, it has been alleged, depicted the president as a donkey.

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Burundi

Peace is nice unless it's phoney

Sep 14th 2006 | BUJUMBURA
From The Economist print edition

A ceasefire deal is signed against a troubled background

AFP

Nkurunziza (left) fondly embraces Rwasa

THE mood was jubilant last week as the Burundi government signed a ceasefire deal with its last remaining rebel group, the National Liberation Forces (FNL). Agathon Rwasa, the FNL's leader, has promised either to integrate his fighters into the army or demobilise them within a month. The deal was the last part of a peace process that ended more than a decade of violence between Hutu rebels and an army dominated by the Tutsi minority. Last year another former Hutu rebel group, the Forces for the Defence of Democracy (FDD), won a landslide election, propelling its leader, Pierre Nkurunziza, to the presidency. He and Mr Rwasa embraced under the watchful eye of South Africa's president, Thabo Mbeki, whose staff had helped to broker the peace talks.

But international observers remain sceptical. Why, one of them questioned, did Mr Rwasa drop, at the last minute, long-held demands for the army to be restructured and for a national reconciliation process to take place? There was no explanation. Nor has the government promised much in return: even Mr Rwasa's personal future is in the air. Over the past few months the security services have rounded up hundreds of FNL members and sympathisers. The UN has denounced the torture and summary execution of dozens of them. Many wonder whether the agreement can hold.

The fighting may have stopped but the country's politics remains turbulent. Last week one of the two vice-presidents, Alice Nzomukunda, resigned, accusing her FDD colleagues of using high office to flout human rights and steal money. Repeating the complaints of local activists and newspapers, she gave warning that the regime was drifting into authoritarian ways.

Last month the government claimed to have foiled a coup. To many, this seems to have been little more than an excuse for cracking down on opponents. Eight prominent politicians and army officers were arrested, including a former president and vice-president. There are credible reports that some were tortured—their lawyers produced pictures of horribly wounded backs and limbs—and the police have failed to show any evidence against them.

One man, whose confession led to the arrest of the former president and his deputy, used a smuggled phone in his prison cell to tell a local radio station that the plot had been staged to nab the regime's critics. The government insists that the Supreme Court, whose judges were appointed by Mr Nkurunziza, must decide on the case.

Donors, who were once fairly hopeful about Burundi, have growing doubts. There have been questions about the sale of the president's aeroplane, which was given away at a suspiciously low price. And the European Union issued a statement in June about €5m ($6.4m) of its development money that had apparently gone missing.

Mr Nkurunziza has been in power for 13 months, the longest a democratic government in Burundi has ever lasted. But in December the last of the UN's 3,000 peacekeepers are due to quit, leaving Burundians to wonder for how much longer the uneasy peace will hold.

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Côte d'Ivoire

Poisonous days

Sep 14th 2006 | ABIDJAN
From The Economist print edition

A toxic-waste scandal shows up the country's fragility

AFP

Perilous slops from an oil cargo

IT IS not normal for an environmental scandal to bring down a government, but then Côte d'Ivoire is anything but normal. The country, once West Africa's most stable, has been split in two by a four-year civil war. A succession of peace deals imposed an unwieldy national-unity government composed of members of the ruling party, the opposition, some former rebels and others. On September 6th, as the growing scale of a toxic-waste dumping scandal became clear, the prime minister, Charles Konan Banny, offered the resignation of this government. But at this the cabinet expressed bewilderment, and some ministers are refusing to take part in the new government that Mr Banny, who was asked to stay on by President Laurent Gbagbo, hopes to name soon.

Meanwhile the numbers affected by toxic waste keep growing: by this week, six people had died and more than 16,000 had sought treatment. The crisis began in August when 528 cubic metres (116,000 gallons) of toxic liquid unloaded from a ship called the *Proba Koala* were dumped in 11 open-air sites in residential areas around the commercial capital, Abidjan. The Dutch-based company which chartered the boat, Trafigura Beheer BV, says that it had informed the Ivorian authorities that the “residue washings [slops] from its gasoline cargo” were dangerous, and that, from then on, it was Ivorian responsibility to dispose of the stuff safely.

That did not happen. More and more people began to fall ill, and thousands took to the streets in protest, but the government's response was slow. Yet when Mr Banny offered its resignation, opposition and rebel ministers were sceptical, arguing that the supposedly neutral prime minister was just using the toxic-waste scandal to push through a cabinet reshuffle.

The scandal shows up the ineffectiveness of a national-unity government composed of factions that disagree on just about everything. The government took too long to act, and then got lost in mudslinging over who was to blame. The port authority, run by one of Mr Gbagbo's cronies, and the minister of transport, an opposition politician, are accusing one another. And now that the government no longer exists, who will clear up the mess?

A team of French experts has arrived to try to identify what exactly the liquid was, and several other Western countries have said they will help. The Dutch government is investigating the role of the chartering company. Meanwhile the hospitals are short of medicine, and all unemployed doctors have

been called up.

The political fallout from the scandal reveals just how fragile the peace process is. On September 20th the UN will examine the Ivorian crisis at a special meeting in New York. Elections are due in October but will not happen: the country is still split in half and electoral lists have not been drawn up. The UN-appointed mediators of the International Working Group have accused all sides of failing to work towards peace. At the same time, the group made it clear where it felt the fault lies: Mr Banny has not been given the powers he needs to take the country to elections, and it recommended a new UN resolution ensuring that he gets them.

This, by implication, allots the largest share of the blame for the botched peace process to Mr Gbagbo. The president's supporters, already angry, will be infuriated if the UN votes for a resolution reinforcing the prime minister's mandate. Yet this is what it is likely to do next month.

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Italy

Stormier weather ahead

Sep 14th 2006 | ROME
From The Economist print edition

After a good summer, Romano Prodi's government faces harder economic times

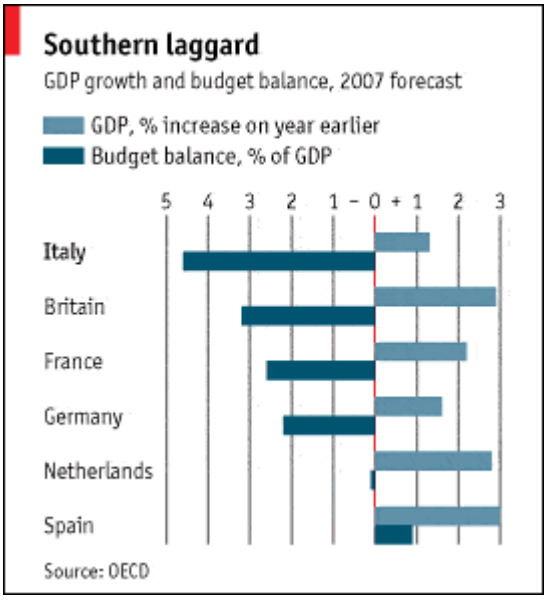
HAS there ever been a sunnier Italian summer? August was dull, but June was radiant and July scorching. September is proving unseasonably hot. The sunniness has not been confined to the weather. At first blush, good news has been piling up on the desk of Italy's finance minister, Tommaso Padoa-Schioppa, ever since he said in June that the state of the public accounts was worse than in 1992 (the year Italy and Britain were forced out of Europe's exchange-rate mechanism).

First it became clear that the economy was rebounding faster than expected. Last week the Paris-based OECD raised its forecast of Italy's 2006 GDP growth from 1.4% to 1.8% (though this is still the slowest in Europe). Then the government found that enhanced growth was feeding into higher tax revenues. So much so that Romano Prodi, the leader of Italy's centre-left government, was able to announce that he was jettisoning €5 billion ($6.5 billion) of the spending cuts that he had planned for 2007. He did not, he said, “want to make Italians weep”.

Since then some figures have got better still. Italy's public borrowing requirement for the first eight months of the year was €36.4 billion, some €22 billion less than in 2005. Officials are now pencilling in a 2006 budget deficit of 3.8-3.9% of GDP. But, in an analysis just posted on an Italian economics website, www.lavoce.info, two of the country's leading public-finance experts, Tito Boeri and Pietro Garibaldi, argue that this is pessimistic and that nobody should be surprised “if we end the year not far off [the euro-area limit of] 3%”. Either way, the picture looks far healthier than the 4.6% that is still forecast for next year by the OECD (see chart).

All this seems bizarrely at odds with the growing belief, particularly in London, that Italy may risk falling out of the euro. A study being published shortly by a London-based think-tank, the Centre for European Reform (CER), puts the odds of this happening at a daunting 40%. Mr Padoa-Schioppa is scathing about such talk. “My time is rather short, and I decided not to spend any of it on nonsensical scenarios,” he

says. “That is a nonsensical scenario.”



Is it? There are, in fact, two variants of it. One envisages Italy's public finances deteriorating to the point where its debt loses investment grade (which would require only two further downgrades by the main rating agencies). That would sharply raise debt-servicing costs, pitching the government into a downward spiral of surging interest rates and rising deficits.

The latest data make such an outcome much less likely in the immediate future. But there is a danger of the government's falling victim to complacency. For the left-wing parties in Mr Prodi's coalition will seize on any reports of smaller budget deficits to demand fewer cuts in next year's budget. If the world economy were suddenly to turn down, which is by no means impossible, the deterioration in Italy's public finances could be sudden.

Italy has not only a substantial budget deficit but, more tellingly, the world's third-largest debt. Last year it rose for the first time as a percentage of GDP (to around 108%). The primary budget surplus (ie, before interest payments) shrank to 0.5% of GDP, down from almost 5% in 2000. As the CER pamphlet notes, “Italy needs to run a primary budget surplus of 2-3% of GDP to prevent the ratio of public debt to GDP from rising further.” In other words, Mr Padoa-Schioppa's warnings earlier this year were objectively true: for all the recent improvements, the underlying situation may be worse than in 1992.

Given that, Mr Prodi's readiness to trim his planned budget cuts has, not surprisingly, caused concern. The OECD said it was “disappointed”. An executive board member of the European Central Bank, Lorenzo Bini Smaghi, noted that revenue increases were a “temporary factor which may not be repeated”. Joaquín Almunia, the European economics commissioner, stressed that, for a country whose debts exceed annual output, “tidying up public finances is not merely a case of bringing the budget deficit down”. Seen from Brussels, Italy is increasingly the big test of the new (and weaker) stability pact, which is supposed to set fiscal rules for euro members. Under it, governments get more flexibility in bad times—but they are meant to show greater discipline in good times.

Mr Padoa-Schioppa says that the cabinet agreed to the €5 billion relaxation because it matched the structural element of this year's revenue improvement. As for other budget cuts, he detects “a readiness to accept the basic adjustments we propose”. However, the biggest communist party in government, which has refused to underwrite its medium-term economic strategy, is on record as saying that the budget plans are “unsustainable”. The government is aiming to cut pensions, health spending, public-sector employment and local-government spending. All of these cuts are unpopular with one or more parties within the coalition.

Yet it is the second variant of Italy leaving the euro that should perhaps be more worrying. This envisages the country pulling out because its competitiveness erodes to a point where membership becomes too painful. Indeed, it is this continuing loss of competitiveness, and not its public finances, that may be the biggest economic problem facing Italy. The CER study concludes that it is five minutes to midnight, and that the Italian government “needs to act now to ensure the country's long-term membership of the euro zone”.

Over the past few years Italian competitiveness has deteriorated at an alarming rate. Between 2000 and 2004 “total factor productivity” fell by an average of 1.2% a year, the worst performance in the EU 15 countries. At the same time, both inflation and nominal wage growth have been higher than in other euro members, especially Germany.

Mr Padoa-Schioppa sees his main task as “making the economy better fit for growth”. The growth will depend largely on the efforts of the private sector and, to the extent that the public sector can help, on further liberalisation by ministries other than his own. But a defiantly reforming 2007 budget remains crucial to the country's economic prospects. Italy has, in effect, already used up this year's unexpected windfall. The government has three years ahead without any elections, when it could push through big reforms. If it fails to do so because some parties in the coalition resist, the consequences could be dire. The warmth of summer can give way to colder weather surprisingly quickly.

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Italy's media law

Berlusconi in a box

Sep 14th 2006 | ROME
From The Economist print edition

Controversy over a law to avert conflicts of interest

IT IS an issue that has bedevilled Italian politics for over a decade: what to do about Silvio Berlusconi's twin roles as politician and media mogul? The former prime minister and his family control a huge media empire that includes a publisher, two newspapers and all three of Italy's biggest private television networks. When he was in power in 1994, and again in 2001-06, he was able to influence the three state-owned channels as well—giving him direct influence over 90% of Italian terrestrial television.

This week a parliamentary committee began discussing a bill, tabled by the whip of the biggest group in Romano Prodi's centre-left government, that would tackle such conflicts of interest. The boss of Silvio Berlusconi's TV empire, Mediaset, likened it to the stringing-up of Benito Mussolini by communist partisans. But what eventually emerges will be far less drastic.

As it stands the bill would create a special watchdog authority. It would force politicians with non-property assets of more than €10m ($13m) to hand them over to a “blind trust”, and require similar arrangements for all assets owned by office-holders in the energy, defence and media businesses. Such a law would replace one approved by parliament in 2004 (when Mr Berlusconi was in power) that was widely lambasted as toothless.

The Prodi government has said it will amend the bill. Its final shape will depend on painful and difficult compromises both within the governing coalition and, quite possibly, between government and opposition. Most leftist politicians regard their failure to curb Mr Berlusconi's media power before he returned to office in 2001 as an historic error. But, with a majority of only two seats in the Senate, they could yet find themselves dependent on the centre-right to pass the new law.

There are also wide differences over how broadly it should be drawn. The Italy of Values party, a small outfit led by a former prosecutor, Antonio Di Pietro, who spent the heyday of his career trying to send Mr Berlusconi to jail, wants a tough, radical measure. But some fear that voters would react against what might look like a crude reprisal against the former prime minister. Earlier this month Mr Prodi's communications minister said that an answer might be found that “in no way touches Silvio Berlusconi in person”. For the sake of Italian democracy, something a bit bolder should at least be tried.

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Germany and peacekeeping

Afghan angst

Sep 14th 2006 | BERLIN AND MAZAR-E-SHARIF
From The Economist print edition

A fierce debate about whether to stay in a country racked by violence

AP

Soldiering on, in a faraway country

THE use of shipping containers as living quarters is generally a sign of transience. But at Camp Marmal near Mazar-e-Sharif, the main base in northern Afghanistan of Germany's forces, it seems to show permanence. The containers are heavily protected against rocket attacks by steel plates on the sides and by a thick layer of sand on top. Such armour suggests that NATO troops will stay for some time. Indeed, NATO commanders have this week been lobbying for reinforcements, which most countries are refusing to send.

Germany, which has the largest number of NATO troops in Afghanistan after Britain and is now in command in the north, must soon decide whether to keep even those it has in the country. One factor complicating the debate will be the recent back-and-forth argument over sending troops to Lebanon. This week the German cabinet approved the dispatch of 2,400 naval and air troops to patrol the Lebanese coast. Worries about possible clashes with Israeli troops—a special German sensitivity—have precluded earlier notions of sending ground forces.

The debates about Lebanon and Afghanistan have featured similar concerns. One is over the rules of engagement, which have unhelpfully restricted what German troops are allowed to do in overseas missions, not least because politicians fear a backlash if any soldiers are killed in combat. And there are still those who question the country's readiness to send any troops into battle anywhere.

Germany has historic ties with Afghanistan, which in the 1970s was a big recipient of German aid. That made it easier to decide in 2002, after the defeat of the Taliban government, to send troops (there are now over 2,800), as well as to contribute to the process of democratisation. Germany is now playing a leading role in efforts to rebuild Afghanistan's institutions. Its projects range from setting up a foreign-news department at the country's state television to training police officers. And it is testing out provincial reconstruction teams, mixes of military and civil groups that are now widely touted as a key tool of nation-building.

Most teams have ended up being mainly military. But the Germans are trying to give life to the dual concept at their bases in northern Afghanistan. They are jointly led by a military commander and a diplomat, and the soldiers are complemented by teams of civil servants and development workers. The difficulty is that the security situation, which has worsened in the north (though it is nothing like as bad as the south), is driving a wedge between the military and civil sides.

After several attacks on German soldiers, most patrols now leave their bases only in armoured vehicles. This makes it hard to reach remote villages, and also creates suspicion between the populace and the troops, making the latter appear more like occupiers. To protect themselves, aid workers have even removed from their vehicles what was once seen as a guarantee of goodwill: the German flag.

Yet for Frank-Walter Steinmeier, Germany's foreign minister, these difficulties are no reason to pull the troops out of Afghanistan. Rather, he says, they show that such efforts will take more time than had been expected. And that may mean remaining in Afghanistan for years to come.

Most members of parliament will agree. But with German troops already in Congo, and warships now on the way to Lebanon, some pundits are arguing that the armed forces cannot be stretched indefinitely. Others are saying that all troops should come home as soon as possible. Berlin will be torn, says Citha Maass of the German Institute for International and Security Affairs, as other countries keep pushing it to do more, for instance to interpret its mandate in Afghanistan more robustly (although, contrary to some reports, nobody expects German forces to go south). But, given how many missions the country has now taken on, it is also time for German politicians to acknowledge openly that their soldiers, like others, may die in combat.

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Construction in Spain

Building blocks

Sep 14th 2006 | SESEñA
From The Economist print edition

The bad side-effects of a housing boom

LONG before you reach Seseña, on the new toll road south of Madrid, you see the cranes. They clutter the skyline above 100 huge apartment blocks at this half-built new town emerging from a dusty, empty plain. This huge housing project, being built in a small country town, is a symbol of today's Spain. It represents a booming economy, a dangerously overheated housing market and—according to the new mayor—a worrying dose of municipal greed and corruption.

More than 13,000 apartments are being built in Seseña, the biggest single housing development in a country obsessed with building. Young first-time buyers from Madrid will start moving in later this year. They have been forced 40km (25 miles) out of the capital by prices that have more than doubled since 1997. Seseña, a town of fewer than 10,000 people, is now preparing to welcome 40,000 new arrivals.

The building boom creates lots of wealth. It pays the wages of hard-hatted workers and, so long as Spain's housing bubble does not burst, should make its promoter rich. It also helps to fill the local town hall's coffers with fees from building licences and other taxes. Some councillors benefit directly. Two are on the promoter's payroll, as is the daughter of a third.

The new mayor, Manuel Fuentes, notes that permission to build was rushed through just before he was elected. “It was all very quick and not at all transparent.” State prosecutors have been asked to investigate. The promoter denies corrupting councillors. They also deny any wrongdoing. No criminal charges have been laid. Yet Seseña's name has now joined the growing list of Spanish towns hit by construction-related scandals.

Spaniards have long suspected that there is graft in their town halls, whichever party runs them. But it was only when a dozen councillors from the southern resort of Marbella were arrested in March that hard evidence came out. Marbella is now being run by administrators appointed by a regional authority. Illegally built holiday homes may be bulldozed. Local democracy is, in effect, dead.

Fresh scandals involving town halls and construction projects now emerge almost weekly. Marbella's councillors are alleged to have taken bribes, but the corruption elsewhere is often more subtle. As Spain builds, town halls increasingly come to depend on income from licences, land sales and property taxes. A mayor who sells municipal land, or pushes through a new housing development, bending the law if necessary, gets more to spend on vote-winning projects.

Because of the opaqueness of municipal accounting, it is hard to say just how dependent town halls now are on building. Estimates for the resorts around Marbella run as high as 70% of total income. Government and prosecutors have usually turned a blind eye, as nobody wants to kill the golden goose of construction.

“The worst thing is that it has just become normal,” says Alejandra Gómez-Céspedes, a criminologist at Malaga University. “When you apply the law, it is as if you are acting against people's civil liberties.” Every year the number of houses being built rises. Last year around 715,000 were started (compared with some 225,000 in Britain, which has a population one-third bigger than Spain's). The Marbella case shows that the law is at last being applied in some places. Spain's Civil Guard chief plans to set up special units to tackle municipal corruption.

Another danger lurks for town halls, however. Spain's housing market may crash, bringing a sudden halt to all building. How will they pay the bills then?

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Romania's government

High and low

Sep 14th 2006 | BUCHAREST
From The Economist print edition

Romania looks wobbly, just ahead of its entry into the European Union

AFP

Basescu waves off stroppy underlings

A STRONG reformist president and government have boosted Romania's chances of joining the European Union next January. But the country's progress has often been more a matter of image than reality—and now its fragile ruling coalition is cracking.

Indeed, were it not for the plan to join the EU, an early election would now be in prospect in what will be the biggest and poorest of its new members. A blizzard of scandals, rows and resignations have hit the centre-right Justice and Truth Alliance, which comprises Democrats (the party of the president, Traian Basescu) and Liberals (led by his prime minister, Calin Popescu Tariceanu). The two men have fallen out badly. Mr Tariceanu wrongfooted the president by instigating a statement calling for the withdrawal of Romanian troops from Iraq, just as Mr Basescu was going to Washington, hoping to win visa-free travel for Romanians as reward for his country's Atlanticist foreign policy.

Another long-running public spat between the two concerns Dinu Patriciu, head of Romania's second-biggest oil firm, Rompetrol. Prosecutors are investigating his role in the company's privatisation. Mr Basescu defends the investigation as part of a new anti-corruption drive. Others say it was started only because Mr Patriciu is a Liberal and friend of Mr Tariceanu. Mr Basescu, a former sea captain who has retained a naval manner in dealing with stroppy underlings, says he now regrets his choice of prime minister.

Mr Basescu and Mr Tariceanu are vying to take credit for the declassification of police files on politicians, priests and even athletes. Billed as a process of moral and political cleansing, it has prompted a frenzy of juicy headlines. Mona Musca, who was an observer at the European Parliament and a culture minister, was sacked by her party after allegations of collaboration with the communist-era secret police, the Securitate, proved true.

So far, Mr Basescu, the country's most-trusted politician, has managed to turn most of this to his advantage. Last month, the heads of Romania's leading spy agencies, along with the top prosecutor, quit after they failed to keep track of Omar Hayssam, a Syrian-born businessman arrested on terrorism charges, who fled Romania after being released from prison on parole for health reasons. Mr Hayssam was due to stand trial on fraud and money-laundering charges, as well as for his alleged role in the kidnapping of three Romanian journalists in Iraq. The scandal gave Mr Basescu the excuse to replace the long-serving spy chiefs, as part of his attempts to restructure the bloated and over-mighty intelligence

services.

Mr Basescu is not just a wily operator. He has a popular touch too. Last month he paid a surprise visit to Romanian troops in Iraq and Afghanistan, soothing national pride that had been hurt by a report in the *Kansas City Star* mocking Romanian troops in Afghanistan for frivolity, incompetence and pilfering. At home, he joined a campaign to keep the Danube delta clean by distributing litter sacks to tourists. So far, this sort of thing has given him the upper hand over Mr Tariceanu.

Yet some wonder what secrets might be lurking in the president's own past. As a well-travelled sea captain at a time when most Romanians were stuck at home, it would be odd if he had had no contact with the secret police. That is something his enemies readily assert. But so far the files show no trace of his career.

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Central bankers under fire

Out of bounds

Sep 14th 2006 | WARSAW
From The Economist print edition

Leszek Balcerowicz, an icon of reform, is under attack

CENTRAL bankers usually like to stay out of the limelight. This week was an exception. In Russia, the central bank's deputy chairman, Andrei Kozlov, was shot dead in Moscow. He had been closing down dodgy banks thought to be involved in money laundering. Less dramatically, the governor of Poland's central bank, Leszek Balcerowicz, was under fire from enemies in Warsaw.

Mr Balcerowicz is widely seen as the father of Poland's economic success. As finance minister in the 1990s, he helped to transform a ruined state-directed economy into a thriving capitalist one. But critics say that, under his stewardship at both the finance ministry and now at the central bank, millions of Poles have lost savings and jobs. He has followed a needlessly harsh monetary policy, and allowed commercial banks to be sold to foreigners. As a member of the Communist Party until 1981, Mr Balcerowicz is distrusted by the former dissidents who now run the country.

His term runs out early next year. But he faces months of difficulty until then. The government has just created a single financial regulator, not because it is a desirable idea but to weaken the central bank. Outsiders have leapt to defend Mr Balcerowicz's independence, including the European Central Bank. But that counts for little with the government's prickly parliamentary deputies, who have set up a committee to investigate banking policy since 1989.

Members of the committee accuse Mr Balcerowicz of many sins. One is backing the merger of two banks owned by Italy's UniCredit earlier this year. That was contested by the government but backed by the European competition commissioner. Unicredit came to terms with the government, but Mr Balcerowicz has not been forgiven for his lack of economic patriotism. He has been summoned by the committee, but declines to appear, at least until a court decision on its constitutionality later this month.

The committee has also questioned Mr Balcerowicz's wife, Ewa, who heads CASE, a prominent Warsaw think-tank. Members hint that her husband may have abused his position to channel funds her way. Both he and she deny claims of a conflict of interest.

Most of the government's sleaze-busting has been in the shadowy world of intelligence, where outsiders give the government the benefit of the doubt. But attacking Mr Balcerowicz looks unwise. For all his faults, he represents a predictable, prosperous and law-abiding Poland. Just now that is an image that needs polishing, not denting.

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Charlemagne

Migration migraine

Sep 14th 2006
From The Economist print edition

Immigration is a Europe-wide concern. It is not clear, though, that it needs a European solution

THE young man from Senegal was one of roughly 20,000 who have arrived so far this year in Spain's Canary Islands, trying to reach Europe. The waters around the Canaries are becoming a humanitarian disaster. Thousands drown before they reach the shore of the closest part of Europe to west Africa, almost 1,000 miles (1,600km) away. But the young man was not deterred. If he got the chance, he said, he would try again tomorrow.

All round Europe immigrants are, literally, dying to get in. Many Europeans say that immigration is an "important" or "extremely important threat". Managing immigration is now "the greatest challenge facing all European governments", according to John Reid, Britain's home secretary. Nicolas Sarkozy, interior minister and presidential candidate, has launched a get-tough campaign that may push the issue up the agenda in next year's French presidential election. This summer's break-up of the Dutch coalition was triggered by disputes over the tough policy of the immigration minister, Rita Verdonk.

The causes of these worries range from xenophobia to terrorism and the perceived failure of multiculturalism. But one is simply that people believe immigration to be out of control. The Canaries took in more boat people in August than in the whole of 2005. In May 2004, when eight central European countries joined the European Union, the British government blithely said that some 13,000 workers would arrive each year from the new members. In fact, 25 times as many did, leaving the government looking incompetent as well as complacent. Not surprisingly, people believe not just that the number of immigrants is growing exponentially but that governments cannot stop it.

There is only a certain amount that any reasonable government can do. Nobody suggests building great walls like China's to keep the hordes out. Civilised governments cannot forcibly deport millions of illegal entrants (though Italy has been accused of sometimes doing this). Every rich country, America included, is under the same sort of pressure as Europe. It is also worth stressing that governments should not try to stop all immigration, even if they could. Immigrants own and run shops, serve in restaurants and staff hospitals (many of the doctors and nurses who work in Britain's health service have trained abroad).

Yet for all these positive arguments, the backlash against legal and, especially, illegal immigration seems likely to grow if the subject is ignored. That makes it all the more crucial that governments do what they

can. The worry is that their efforts so far may in some respects have made things worse.

Some countries are serial granters of amnesties. Last year Spain decided to let illegal immigrants remain provided that were working for at least six months. Italy also likes amnesties, arguing that they encourage black-market workers to pay taxes. At the same time, other countries have become tougher. In France riot police recently evicted 500 people, mostly illegal immigrants from west Africa, from an abandoned dormitory in a university near Paris. There was a similar incoherence when the EU expanded to central Europe. Britain, Ireland and Sweden opened up their labour markets to new workers. The other EU countries imposed restrictions to try to keep them out.

In a world of separate labour markets and national border controls, differing policies might just reflect different national choices. But Europeans are free to travel, live and work wherever they want. In half the EU countries (those in the Schengen passport-free zone) there aren't even any border controls. The right of free movement of labour is one of the EU's undoubted successes. But it has a downside: if Italy (say) grants illegal immigrants an amnesty, they are free to disappear over the Alps to France or Germany—and many do just that.

In these circumstances, immigration policies are not merely different, they are contradictory. It makes little sense, from a European point of view, for France to get tough on illegal immigrants if Spain is granting an amnesty. This produces confusion at the European level, making it harder to manage legal migration (and properly managed legal migration may be the best single cure for illegal migration).

Europe's incoherence also leads to what is known as “squeezing the balloon”. A crackdown on immigration in one place swiftly produces a huge bulge somewhere else. The flood of immigrants to the Canaries reflects a tightening of the border at Gibraltar. One reason 750,000 Poles and other central Europeans went to Britain and Ireland after 2004 is that they were hampered from working legally in other big EU countries. The most likely successor to Britain's Tony Blair, Gordon Brown, now says he wants to limit access to Britain's labour market for people from the next two EU entrants, Bulgaria and Romania.

A job for Europe

In response to such beggar-my-neighbour actions, the leaders of France, Italy and Spain this week proposed to increase the European Union's competence in immigration policy. They have a good case. And like immigrants themselves, they are pushing at an open door: unsurprisingly, the European Commission would graciously accept more powers over immigration.

Nobody disputes that European countries need better co-ordination. It is not obvious, though, that this must mean passing authority up to Brussels. Immigration touches on the most basic concepts of nationhood, such as when immigrants may become citizens. Citizenship, like other such matters, is rightly a prerogative of member countries, not the EU.

The best role for the EU should be to help governments co-operate, not to usurp national powers. And one aim should be to persuade Europeans that immigration is not, as they think, dangerously out of control. Aligning national policies might provide some reassurance. A big row about the powers of Brussels would only make matters worse.

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Tax politics

Changing the menu

Sep 14th 2006
From The Economist print edition

The debate at the next election will be over how to tax, not how much

IN THE past two elections the politics of “tax and spend” have been stuck in a rut. Once the vociferous champion of lower taxes, the Conservative opposition proposed only modest tax cuts in 2001 and even smaller ones in 2005. The governing Labour Party nonetheless depicted these timid pledges as threatening a mad axeman's assault on public spending. The Liberal Democrats, Britain's third party, for their part promised to raise the tax burden still higher to pay for pet schemes.

Since the election in May 2005 the menu has at last changed. The new offering is even more dispiriting, however, for those who yearn for a smaller state. True, the Lib Dems are no longer intent on self-harm by proposing higher taxes. But under David Cameron's leadership, the Conservatives will not make any explicit offer of tax cuts at all.

The autumn conference season that starts with the Lib Dems in Brighton on September 17th will be an occasion for recidivists in both the opposition parties to moan about these somersaults. Left-wing Lib Dems are aggrieved that the party leadership no longer wants to clobber high earners with a 50% top rate of income tax. Within the Conservative ranks there are plenty of stalwarts who gag on the notion of fighting the next election without expressly promising lower taxation.

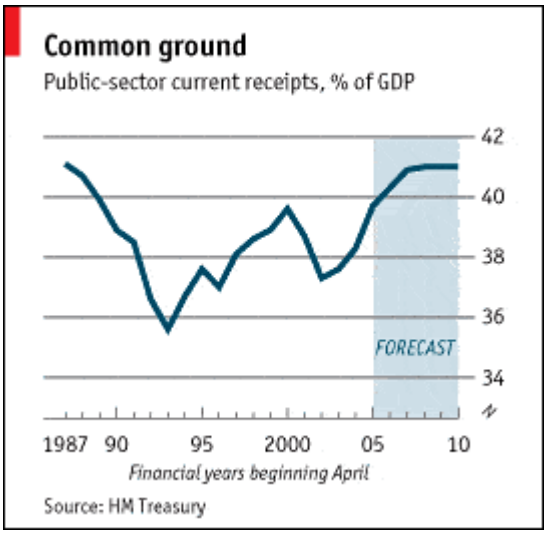
But electoral realpolitik should allow the party leaders to push through the new policies. The Lib Dems have finally spotted that a commitment to raise taxes is unpopular. But strangely enough, voters are just as suspicious about a pledge to cut them. The Conservatives have concluded that they have nothing to gain by being painted into a corner once again as tax-cutters who will slash public spending.

Yet if the opposition parties have had to swallow their pride, so too has Labour. When Gordon Brown announced big tax increases in 2002 to finance more health-service spending, the initial public reaction appeared favourable. Labour dared to think that it had forged a new consensus supporting higher taxation. Such hopes were quickly dashed once the tax rises came into effect in 2003. Since then the chancellor of the exchequer has done his utmost to avoid a third-term tax increase.

The three main parties have thus converged on a common position, endorsing a tax burden of two-fifths

of GDP, roughly its level two decades ago (see chart). That is much higher than in America but a bit lower than in the euro area. Politicians of all colours now judge that this is what British voters are willing to settle for.

Oddly enough, this limp denouement to the protracted argument over the right level of taxation has sparked off a debate that may prove more productive—about the right kind of taxes to have. Some of the suggestions are better than others. Stephen Byers, a former Labour minister and a strong supporter of Tony Blair, has called for the abolition of inheritance tax. However, this proposal, which cheekily invaded the chancellor's turf, owed more to internal party politicking over the succession to Mr Blair than to any convincing economic rationale.



Inheritance tax is undoubtedly unpopular but it deters saving less than most other taxes on capital accumulation, as Alan Auerbach, an economist at the University of California, Berkeley, pointed out in a recent lecture in London. This is because it falls in part on money that people were setting aside anyway for their old age, which should be unaffected by the prospect of the tax, as well as on intentional legacies.

A better candidate for the chop is stamp duty on share deals, which George Osborne, the Conservative shadow chancellor, now proposes doing. Economists generally frown on taxing financial transactions because that gums up markets. Stamp duty is cheap to collect but it raises the cost of capital for firms.

There may be reasons for getting rid of individual taxes, but piecemeal abolition can cost political lives. Margaret Thatcher paid dear for her decision to replace domestic rates based on property values with the reviled poll tax. It is wrong in any event to consider a single tax in isolation. Inheritance tax and stamp duty will each raise £3.6 billion ($6.8 billion) this year. If either were to go, that revenue would have to be found elsewhere by raising other taxes. The case for cancelling any one tax must take into account the overall impact.

Green shoots

The cause of systematic tax reform will be assisted by a review announced on September 4th by the Institute for Fiscal Studies, a think-tank. Chaired by Sir James Mirrlees, a joint winner of the Nobel prize for economics, the review's recommendations on tax design will be published in early 2008, thus helping to shape the debate before the next election.

One way forward now favoured by the two main opposition parties is to raise the share of green taxes. At first sight, this appears to be a political no-brainer. Like “sin taxes” on smoking and drinking, green taxes seek to restrain “bad” environmental habits while handily raising oodles of cash. In practice, they are often beset by difficulties. Mr Brown was forced to drop the policy of raising road-fuel taxes faster than inflation after angry protesters came close to paralysing the country in 2000.

Green taxes may be tricky, but they have an allure that tax simplification will never enjoy. Yet Mr Brown's incessant micro-meddling has made fiscal complexity a macro-problem, especially for businesses. For many individuals, the interaction of benefits and taxes is just as complicated and also creates high marginal effective tax rates that discourage effort.

The new political consensus about the level of taxation will undoubtedly disappoint many attending the party conferences over the next three weeks, but it closes what had become a sterile argument. Now that they have changed the subject, politicians should find that they can present some constructive proposals, not least in local taxation. The tax system is in such a muddle that reformers can hardly fail to make a difference.

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Criminal justice

Third time unlucky

Sep 14th 2006
From The Economist print edition

New rules on double jeopardy score a first conviction

Reuters

Armed to the hilt

A MILESTONE in English legal history was reached this week when a man who had been cleared 15 years ago of strangling a young mother was convicted of her murder after a re-trial. Under the common-law principle of double jeopardy, no one may be tried twice in the same jurisdiction for an offence of which he has already been acquitted. But this ancient legal safeguard was breached by new rules that came into force last year. These allow re-trial for certain serious crimes when “new and compelling” evidence comes to light.

Double jeopardy is one of the oldest legal concepts in Western tradition, dating at least from the days of Demosthenes. It has been a maxim of English common law for 800 years (though sometimes more honoured in the breach). Enshrined in the constitutions of America, Canada and India, and included as an optional protocol in the European Convention on Human Rights, the ban on double jeopardy is part of the legal legacy Britain gave the world.

Many consider the principle as sacrosanct as habeas corpus or trial by jury. Without it the power to prosecute can be used as an instrument of oppression. But Tony Blair, the prime minister, thinks that Britain's criminal-justice system needs a “profound re-balancing” in favour of the “law-abiding majority”. The double-jeopardy rule was amended to that end.

There is no doubt that William Dunlop, the first person to be convicted under the new rules, did assault Julie Hogg sexually and murder her in 1989. He pleaded guilty on September 11th at the Old Bailey in London. But he told a different tale to two juries in 1991; they failed to reach a verdict and he was formally acquitted. When he admitted the killing later he could be charged only with perjury.

Pressure for a change in the law came after an official inquiry into the murder in 1993 of Stephen Lawrence, a black London schoolboy, found that the principle of double jeopardy could cause “grave injustice to victims and the community”. Three suspects, all white, were acquitted after a private prosecution brought by the Lawrence family collapsed for want of evidence. Despite strong opposition from some civil-liberties campaigners, lawyers and backbench MPs, the government pushed through the double-jeopardy reform as part of the 2003 Criminal Justice Act.

To assuage the fears of those who worry that the new rules will be abused or foster endless uncertainty, the situations in which re-trials can be permitted have been tightly defined. Only cases involving the most serious crimes—such as murder, rape and armed robbery—can be reviewed. Any new investigation must be sanctioned by the director of public prosecutions. Only if he is satisfied that new and compelling evidence has been found will he refer the case to the Court of Appeal. That court must concur with his findings before giving the go-ahead for a new trial. Even human-rights activists agree that it was right for Mr Dunlop to be convicted.

For all the attempt to limit the number of decisions that can be reopened, however, many still fear the weakening of double jeopardy could open the door to a host of re-trials as advances in forensic science, such as the use of DNA, turn up new evidence. According to the Home Office's National Crime Faculty,

there are 35 murder cases in which acquitted defendants could be re-investigated. But the Crown Prosecution Service says that no other cases are being considered for re-trial at present.

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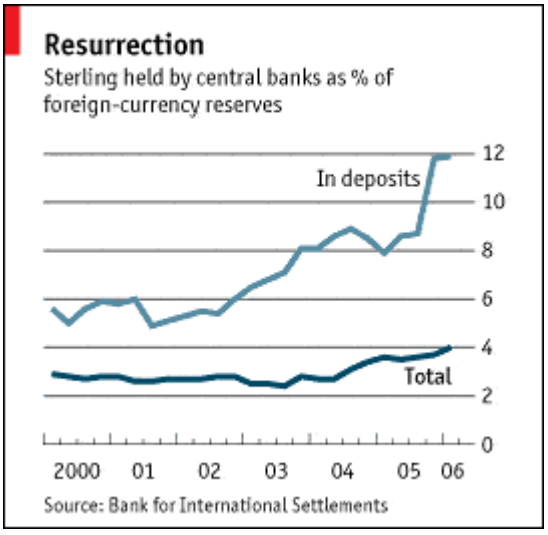
Sterling strength

Reserve power

Sep 14th 2006
From The Economist print edition

The pound gets a seal of approval from central banks



STERLING crises punctuated most of Britain's post-war economic history. But in the past decade, the pound has been rudely robust rather than chronically weak. In recent months, for example, it has at times traded above $1.90.

Many reasons have been advanced to explain sterling's revival as a strong currency. The pound has benefited from a long spell of economic growth together with success in muzzling inflation. It has also gained from the weaknesses of other currencies. The euro has been hobbled by lacklustre growth in the single-currency area and the dollar has been undermined by America's big current-account deficit.

Even so the pound's recent resilience has been puzzling. When sterling climbed above $1.90 at the end of 2004, it was helped by the fact that short-term interest rates were considerably higher in Britain than in the United States. But the pound's surge this summer against the dollar has occurred despite the fact that British rates are now lower than those in America.

One neglected reason is the pound's resuscitation as a reserve currency. Recent figures show that it has knocked the Japanese yen off its perch as the third most popular currency held as reserves by the world's central banks. Admittedly, sterling is still dwarfed by the dollar and the euro. It accounts for 4% of foreign-exchange reserves, compared with 66% for the dollar and 25% for the euro. But after the pound's long, traumatic post-war decline, overtaking the yen still counts as a minor miracle.

Central banks currently hold 70% of their foreign-exchange reserves in longer-term securities and 30% in deposits. In recent years they have been especially keen to raise their holdings of sterling deposits, according to a new report by the Bank for International Settlements. Since the end of 2002 the pound's share of deposits has doubled from 6% to 12% (see chart). An attractive yield is one reason. Another is the growing heft of emerging economies, whose central banks put a bigger chunk of reserves into deposits than do their counterparts in developed countries. The high-yielding pound has gained from this trend.

The published figures for the breakdown of reserves by currency omit China, even though the country accounts for a fifth of foreign-exchange reserves. If it were included, the pound's share of reserves could well be higher than 4%. China is thought to back its currency mainly with securities rather than deposits. But it also appears to be favouring sterling in the hunt for yield.

Nothing can be taken for granted in the foreign-exchange markets. But for the moment, central banks' vote of confidence in sterling seems to be underpinning the pound. As David Bloom, head of currency research at HSBC, points out, traders take the view that what's good for central banks is good enough for them.

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Gambling

Better odds

Sep 14th 2006
From The Economist print edition

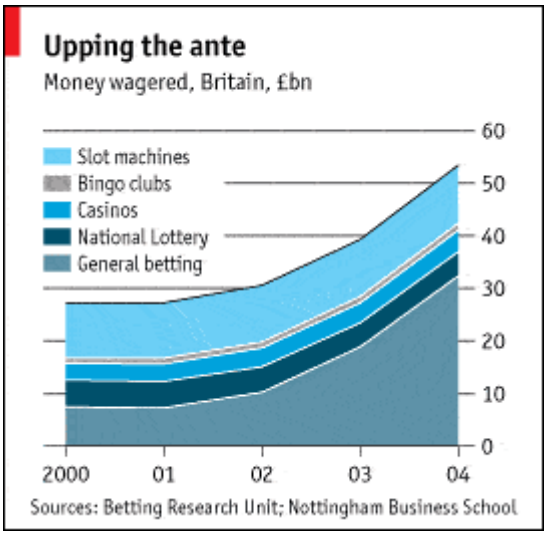
Deregulation has been good for bookmakers but better for gamblers

THE race to license Britain's first super-casino is on, but for those punters who just cannot wait there is an interim flutter to be had. Betfair, a British betting exchange, is quoting odds on which city will win the right to host the casino (Greenwich is the clear favourite). It also offers a chance to wager on the capital having a white Christmas (at ten-to-one against) or who will win the next election (the Tories, if you believe the odds).

"In Britain you can bet anywhere on just about anything," says Leighton Vaughan Williams, who heads the Betting Research Unit at Nottingham Business School. Small wonder that the place is fast becoming the world centre of gambling. It has already produced firms such as Ladbrokes, the biggest publicly quoted gambling business, and Partygaming, the leading online poker site. Earlier this month hearings were held to select a site for a new bricks-and-mortar supercasino. And next year online casinos will be legalised in an effort to regulate and tax a fast-growing industry that, although often British-owned, is served by computers offshore.

The government is hoping to repeat the success it had earlier with the betting industry. After a tax on wagers was abolished in 2001, most British-owned offshore betting businesses moved back and are now under the regulators' eye. Since then bets in Britain have grown rapidly, from £7 billion in 2000 to £32 billion in 2004 (see chart) and an estimated £50 billion or more this year. Some of the fastest growth has been in internet betting, which now accounts for about 15% of all bets placed with British firms. Half is thought to come from gamblers outside Britain.

The biggest winners are punters themselves, as deregulation and competition drive down margins. Five years ago betting firms paid winnings equal to some 70% of the total wagered; now they pay around 93%, contributing to the rapid increase in sums wagered. But gambling firms are doing better too, thanks to higher volumes. They now keep about £3.5 billion after paying out winnings, up from £2 billion five years ago, reckons Mr Vaughan Williams.



Pressure on margins will get even stronger as more bets are made online, where costs are lower and gamblers can easily compare odds. An American study found that, although the average Missouri casino paid out 92.2% of bets as winnings, internet casinos paid out more than 96%.

But the industry's rapid growth has also prompted concern that deregulation has gone too far in Britain and is creating a nation of addicts. So far the data suggest otherwise. A government study in 2004 found that the prevalence of gambling was not only declining but also lower than in many other countries. Some 71% of British respondents said then that they had enjoyed a flutter in the previous year, down from 73% five years earlier. That compares with 82% in Australia, 85% in British Columbia and 81% in Colorado.

If gamblers are playing for higher stakes, so too are bookmakers. Last week Peter Dicks, the non-executive chairman of Sportingbet, became the second boss of a British online-gaming site to be arrested in America, where most internet gambling is illegal, for taking bets from Americans. It is just a matter of time before bookies offer odds on the outcome of his case.

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Social exclusion

Breaking the circle

Sep 14th 2006
From The Economist print edition

New plans to help the poorest of the poor

THREE doors still stand in Gressenhall workhouse, where Norfolk's poorest came for 150 years to seek bread and work. Fathers, mothers and children entered separately this “house of industry” for the destitute. Children wailed for their mothers, the unmarried among whom were forced to dress differently from the rest and excluded from the one decent meal of the year at Christmas. Gressenhall's doors closed for good in 1948, when Britain introduced the welfare state.

All that is a world away from the Bromley By Bow Centre in east London, a community centre run by a charity, where the government launched plans this week to fight social exclusion. The buildings house a nursery, a café and classrooms where those with few skills can acquire some. There are after-school clubs and counselling sessions. This, say ministers, is what family social services should look like.

The government wants to provide more help to families with severe problems, who, it says, have been failed by past initiatives. The idea is to identify problem parents early so that their children are not dragged along the same troubled path. Those deemed most in need of support include very young children whose parents drink, shoot up and so forth, teenaged parents and children in care.

Severe social problems are not limited to the very poor—some children in poor families flourish and some in rich ones do not. But the odds are stacked against those at the bottom. A study in New Zealand that has influenced policymakers in Britain shows, perhaps unsurprisingly, that children in the poorest families are 100 times more likely to have multiple social problems at the age of 15 than children from prosperous homes.

This week's plan for combating social exclusion signals a switch in government thinking. Services once made available to all comers will instead be peddled selectively to those most in need of them. Programmes such as Sure Start, launched in 1999 to provide parenting advice and facilities in Britain's poorest boroughs, have proved popular. But an evaluation this year revealed that better-off families had gained more from it than the poorest ones.

Ministers are keen to point out that they have scoured the world for evidence about social exclusion and how to fight it. The early intervention that will be tested in Britain from 2007, for example, is inspired by work in America and New Zealand. In ten pilot projects, teams led by nurses will make frequent visits to families whose children they reckon are at risk. More inspiration comes from the Netherlands, where the rate of teenage pregnancy has dropped since sex-education classes were changed to let youngsters discuss the subject more openly. The Danish and German model for children in care, in which specially trained teachers take on just a few youngsters and look after them until they grow up, is also reckoned worth a try.

Some have been quick to mock what they see as the government's increasing propensity to meddle. Charities broadly welcome the new emphasis on early and active intervention but warn that it risks stigmatising the poor. Ministers insist that vulnerable groups need all the help they can get, whether they want it or not. And the chancellor who would be prime minister, Gordon Brown, lets it be known that he has always believed in favouring the poorest when it comes to dishing out help.

Nobody really knows how to break the well-documented spiral of deprivation. The children who lived at the workhouse in Gressenhall were never expected to rise above their station in life. This new approach may improve very poor children's chances today to do just that.

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The end of Olde Englande

A lament for Blighty

Sep 14th 2006
From The Economist print edition

Britain is going to the dogs, some say

THE Home Counties are horrified. The British Show Jumping Association has asked police to investigate claims that a mother of two doped ponies in an attempt to help her child win a championship. (Bystanders said they had seen her feeding sweets to the steeds.) Though the police have dropped the matter, mothers at gymkhanas will eye each other even more suspiciously henceforth. Pushy parents are everywhere, it seems, and childhood tainted.

Indeed, the *Daily Telegraph* published a lament for lost childhood on September 12th. More than 100 worthies, including Penelope Leach, a child-care guru, and Philip Pullman and Jacqueline Wilson, well-known writers of children's books, complained that junk food, video games and over-competitive schools were making children sad. They needed more “real play” (perhaps with sticks in woods) and more time with “significant adults” (ie, parents).

That same day those who yearn for the olden days, when children played tag in the summer sunlight and rolled down grassy slopes with friendly dogs called Rover, received two more blows. Ian Pearson, an environment minister, said Britons must prepare to bid farewell to their lawns, as global warming is turning verdant swards into dried-up dust-bowls. And in an attempt to preserve what remains of this green and pleasant land, the Campaign for the Protection of Rural England joined forces with the Royal Automobile Club to huff about the “garish signs and billboards” ruining roads in “pretty rural areas”. They called for a return to fingerposts.

There are other pressing problems—the vanishing Sunday roast, the reform of the Anglican liturgy to make it more “user-friendly” and the tragic disappearance of the milkman. Most worrying are the changes to children's parties, which now cost over £200 a pop, according to a survey in February. Once sprogs would sit in a circle, play pass the parcel and leave (after saying thank you) with a squashed piece of sponge cake in a napkin. Now many have contracted “Posh Party Syndrome” as they struggle to keep up with Posh and Becks (the footballer and his wife), who spent some £10,000 on a birthday celebration for their son.

But all is not lost. Bovril, a traditional hot beef drink served to men in sheds, is back, now the European Union has lifted its ban on Britain's beef products. Tea-time has never been more popular—London hotels are booked up for months in advance. Although the music show “Top of the Pops” has disappeared from the BBC's schedule, Auntie has graciously brought back “Dr Who”—and a new generation can enjoy the deliciously spine-chilling experience of hiding behind the sofa whenever the Daleks appear.

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Bagehot

The charming Mr Johnson

Sep 14th 2006
From The Economist print edition

Gordon Brown's enemies are pinning their hopes on Alan Johnson. But the ex-postman is a canny operator

HEIRS-APPARENT usually have a short life in politics: they are seen off either by other pretenders to the crown or by the wary incumbent. An oddity of Labour's present situation is that the party has lived so long with the near-certainty that, whenever Tony Blair stepped down, Gordon Brown would succeed him. At least until last week the assumption within the party was that Mr Brown might not even face a challenge, other than from some left-wing patsy with a desire for 15 minutes of fame.

That is still quite possible. But the damage that the impatient chancellor has done to himself by appearing to allow the recent cack-handed plot against Mr Blair to proceed has given new hope to the previously dormant Anyone But Brown camp.

Part of the problem for the ABBs has been Mr Brown's proven ability to make life miserable for potential rivals. Ask Alan Milburn, a favourite of Mr Blair's who was effectively driven out of politics by Mr Brown, or Charles Clarke (see article), whose attack on the chancellor last week was repayment for past wounds. The other difficulty faced by those who have dreamed of thwarting Mr Brown has been the lack of a beast big, capable and fearless enough to take him on.

An exception is John Reid. The home secretary is unquestionably of leadership timber. He is a confident performer, clever, more than arrogant enough to see himself in the top job and he plays the game of politics every bit as brutally as Mr Brown. But, unfortunately for him, Mr Reid is very Scottish, and an important element in the case against Mr Brown is that his Scottishness makes him less appealing to the voters of middle England.

That is one reason why Alan Johnson, the education secretary, is currently seen as the only real threat to Mr Brown. In a government in which every other minister seems to speak with a thick Scottish burr, Mr Johnson's authentic “sarf” London accent is refreshing. On its own, however, that would hardly be enough to have secured Mr Johnson odds of seven-to-two in the leadership stakes, while Mr Reid languishes at seven-to-one.

What makes Mr Johnson formidable is a combination of rare political talent, genuine affability and a back-story that, in Labour terms, is to die for. Few contemporary politicians can have had a tougher start in life. His father, a decorator, ran off when he was eight and his mother, a cleaner, died four years later. Thanks to the care of his 15-year-old sister, he avoided being sent to a Barnardo home, but he left school at 15 without a single qualification. After stacking shelves for a while at Tesco, he became a postman in Slough at 18. By then he was already married with two children.

In his late 30s, with a reputation as a stroppy militant, he was appointed a full-time official of the postal-workers' union. Six years later he was elected general-secretary of the merged communication-workers' union, with whose hard-left executive he was increasingly out of sympathy. Indeed, Mr Johnson rapidly became Mr Blair's favourite union boss because he was the only one to support the new leader's bold stroke of revising Clause 4 of the party's constitution, which called for “the common ownership of the means of production, distribution and exchange”. So keen was Mr Blair to have Mr Johnson around that only weeks before the 1997 election that brought Labour to power he had Mr Johnson “parachuted” into the safe seat of Hull West.

It was the way Mr Johnson handled his first big test as a minister that marked him out for future stardom. In the improbable role as minister for higher education, he had to shepherd through the House of Commons a quintessentially Blairite reform—the introduction of differential university tuition fees. The legislation scraped through, saving Mr Blair from the indignity of a vote of confidence despite his large parliamentary majority. Mr Johnson attributed the victory to a “charm offensive” with Mr Clarke (the education secretary). “I did the charming and he was offensive,” said Mr Johnson.

Since then the sharp-suited, gel-haired Mr Johnson has established a reputation as a moderniser no less ardent than Mr Blair and as—perhaps—an even better communicator. Mr Blair can be a little thespian for some tastes, but Mr Johnson always manages to sound like a normal human being, even when dealing with the most complex and thorny issues. It was typical of him that, when made secretary of state at the whizzily re-branded Department of Productivity, Energy and Industry, he quickly decided to revert to its old name of Department of Trade and Industry. DPEI, he said, had prompted descriptions such as “penis and dippy”, so he had sent “a man with a screwdriver” to replace the sign outside.

So far Mr Johnson's only setback has been the hostile reception given to a deal he struck with the unions when he was secretary for work and pensions. To head off a major strike, he agreed that existing public-sector workers would still be allowed to retire at 60 in exchange for new recruits working until they reached 65. Only the unions involved now think the deal can survive.

Over the top or not

As education secretary since May, however, Mr Johnson has shown sureness of touch. Unlike his hapless predecessor, Ruth Kelly, he has taken nearly all the heat out of controversial plans to give schools more autonomy. Moreover, he has done so without conceding an inch to the scheme's critics, whom he accuses of a “bizarre kind of reverse elitism, which tolerates failing comprehensives whilst denigrating any suggestion of diversity”.

There is no doubt that Mr Johnson is intensely ambitious. At 56 he doesn't have all the time in the world and he has already put himself forward as a candidate to replace John Prescott in the job of deputy prime minister. But taking on Mr Brown is another matter. He will wait, sniff the air and watch the polls. Mr Johnson is too shrewd to be anyone's cannon fodder.

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The new titans

Sep 14th 2006
From The Economist print edition

China, India and other developing countries are set to give the world economy its biggest boost in the whole of history, says Pam Woodall. What will that mean for today's rich countries?

LAST year the combined output of emerging economies reached an important milestone: it accounted for more than half of total world GDP (measured at purchasing-power parity). This means that the rich countries no longer dominate the global economy. The developing countries also have a far greater influence on the performance of the rich economies than is generally realised. Emerging economies are driving global growth and having a big impact on developed countries' inflation, interest rates, wages and profits. As these newcomers become more integrated into the global economy and their incomes catch up with the rich countries, they will provide the biggest boost to the world economy since the industrial revolution.

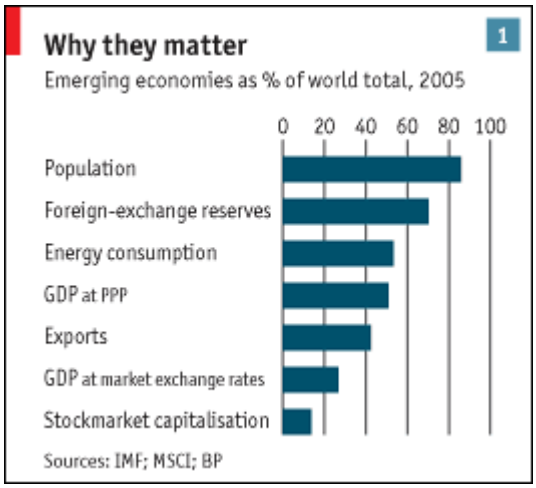
Indeed, it is likely to be the biggest stimulus in history, because the industrial revolution fully involved only one-third of the world's population. By contrast, this new revolution covers most of the globe, so the economic gains—as well as the adjustment pains—will be far bigger. As developing countries and the former Soviet block have embraced market-friendly economic reforms and opened their borders to trade and investment, more countries are industrialising and participating in the global economy than ever before. This survey will map out the many ways in which these economic newcomers are affecting the developed world. As it happens, their influence helps to explain a whole host of puzzling economic developments, such as the record share of profits in national income, sluggish growth in real wages, high oil prices alongside low inflation, low global interest rates and America's vast current-account deficit.

Emerging countries are looming larger in the world economy by a wide range of measures (see chart 1). Their share of world exports has jumped to 43%, from 20% in 1970. They consume over half of the world's energy and have accounted for four-fifths of the growth in oil demand in the past five years. They also hold 70% of the world's foreign-exchange reserves.

Of course there is more than one respectable way of doing the sums. So although measured at purchasing-power parity (which takes account of lower prices in poorer countries) the emerging economies now make up over half of world GDP, at market exchange rates their share is still less than 30%. But even at market exchange rates, they accounted for well over half of the increase in global output last year. And this is not just about China and India: those two together made up less than one-

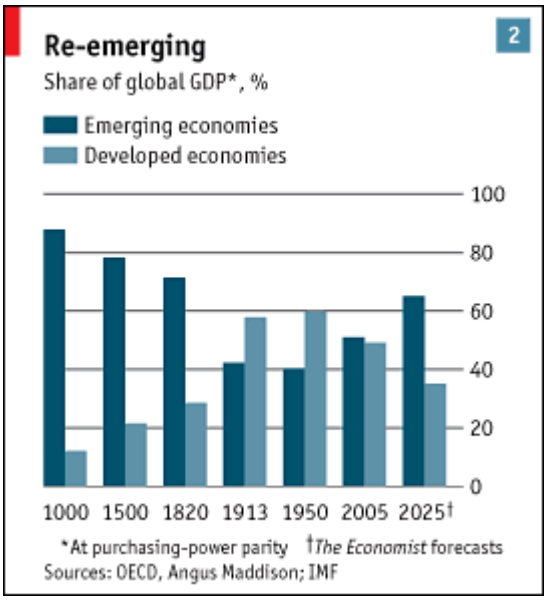
quarter of the total increase in emerging economies' GDP last year.

There is also more than one definition of emerging countries, depending on who does the defining (see article). Perhaps some of these countries should be called re-emerging economies, because they are regaining their former eminence. Until the late 19th century, China and India were the world's two biggest economies. Before the steam engine and the power loom gave Britain its industrial lead, today's emerging economies dominated world output. Estimates by Angus Maddison, an economic historian, suggest that in the 18 centuries up to 1820 these economies produced, on average, 80% of world GDP (see chart 2). But they were left behind by Europe's technological revolution and the first wave of globalisation. By 1950 their share had fallen to 40%.



Now they are on the rebound. In the past five years, their annual growth has averaged almost 7%, its fastest pace in recorded history and well above the 2.3% growth in rich economies. The International Monetary Fund forecasts that in the next five years emerging economies will grow at an average of 6.8% a year, whereas the developed economies will notch up only 2.7%. If both groups continued in this way, in 20 years' time emerging economies would account for two-thirds of global output (at purchasing-power parity). Extrapolation is always risky, but there seems every chance that the relative weight of the new pretenders will rise.

Faster growth spreading more widely across the globe makes a huge difference to global growth rates. Since 2000, world GDP per head has grown by an average of 3.2% a year, thanks to the acceleration in emerging economies. That would beat the 2.9% annual growth during the golden age of 1950-73, when Europe and Japan were rebuilding their economies after the war; and it would certainly exceed growth during the industrial revolution. That growth, too, was driven by technological change and by an explosion in trade and capital flows, but by today's standards it was a glacial affair. Between 1870 and 1913 world GDP per head increased by an average of only 1.3% a year. This means that the first decade of the 21st century could see the fastest growth in average world income in the whole of history.



Financial wobbles this summer acted as a reminder that emerging economies are more volatile than rich-country ones; yet their long-run prospects look excellent, so long as they continue to move towards free and open markets, sound fiscal and monetary policies and better education. Because they start with much less capital per worker than developed economies, they have huge scope for boosting productivity by importing Western machinery and know-how. Catching up is easier than being a leader. When America and Britain were industrialising in the 19th century, they took 50 years to double their real incomes per head; today China is achieving the same feat in nine years.

What's new

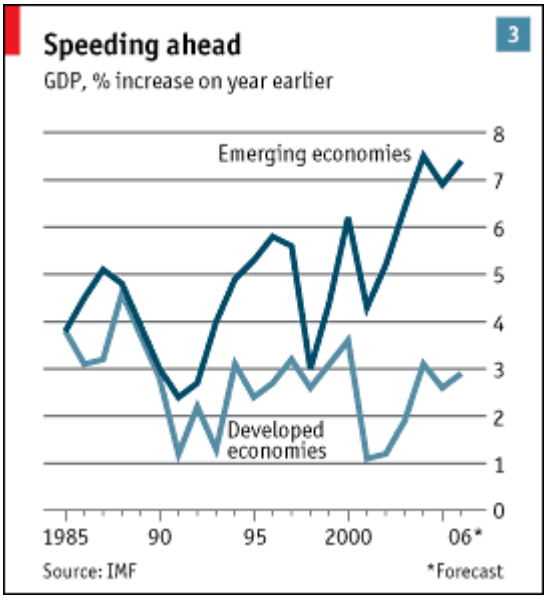
Emerging economies as a group have been growing faster than developed economies for several decades. So why are they now making so much more of a difference to the old rich world? The first reason is that the gap in growth rates between the old and the new world has widened (see chart 3). But more important, emerging economies have become more integrated into the global system of production, with trade and capital flows accelerating relative to GDP in the past ten years.

China joined the World Trade Organisation only in 2001. It is having a bigger global impact than other emerging economies because of its vast size and its unusual openness to trade and investment with the rest of the world. The sum of China's total

exports and imports amounts to around 70% of its GDP, against only 25-30% in India or America. By next year, China is likely to account for 10% of world trade, up from 4% in 2000.

What is also new is that the internet has made it possible radically to reorganise production across borders. Thanks to information technology, many once non-tradable services, such as accounting, can be provided from afar, exposing more sectors in the developed world to competition from India and elsewhere.

Faster growth that lifts the living standards of hundreds of millions of people in poor countries should be a cause for celebration. Instead, many bosses, workers and politicians in the rich world are quaking in their boots as output and jobs shift to low-wage economies in Asia or eastern Europe. Yet on balance, rich countries should gain from poorer ones getting richer. The success of the emerging economies will boost both global demand and supply.



Rising exports give developing countries more money to spend on imports from richer ones. And although their average incomes are still low, their middle classes are expanding fast, creating a vast new market. Over the next decade, almost a billion new consumers will enter the global marketplace as household incomes rise above the threshold at which people generally begin to spend on non-essential goods. Emerging economies have already become important markets for rich-world firms: over half of the combined exports of America, the euro area and Japan go to these poorer economies. The rich economies' trade with developing countries is growing twice as fast as their trade with one another.

The future boost to demand will be large. But more important in the long term will be the stimulus to the world economy from what economists call a “positive supply shock”. As China, India and the former Soviet Union have embraced market capitalism, the global labour force has, in effect, doubled. The world's potential output is also being lifted by rapid productivity gains in developing countries as they try to catch up with the West.

This increased vitality in emerging economies is raising global growth, not substituting for output elsewhere. The newcomers boost real incomes in the rich world by supplying cheaper goods, such as microwave ovens and computers, by allowing multinational firms to reap bigger economies of scale, and by spurring productivity growth through increased competition. They will thus help to lift growth in world GDP just when the rich world's greying populations would otherwise cause it to slow. Developed countries will do better from being part of this fast-growing world than from trying to cling on to a bigger share of a slow-growing one.

Stronger growth in emerging economies will make developed countries as a whole better off, but not everybody will be a winner. The integration of China and other developing countries into the world trading system is causing the biggest shift in relative prices and incomes (of labour, capital, commodities, goods and assets) for at least a century, and this, in turn, is leading to a big redistribution of income. For example, whereas prices of the labour-intensive goods that China and others export are falling, prices of the goods they import, notably oil, are rising.

In particular, the new ascendancy of the emerging economies has changed the relative returns to labour and capital. Because these economies' global integration has made labour more abundant, workers in developed countries have lost some of their bargaining power, which has put downward pressure on real wages. Workers' share of national income in those countries has fallen to its lowest level for decades, whereas the share of profits has surged. It seems that Western workers are not getting their full share of the fruits of globalisation. This is true not just for the lowest-skilled ones but increasingly also for more highly qualified ones in, say, accountancy and computer programming.

If wages continue to disappoint, there could be a backlash from workers and demands for protection from low-cost competition. But countries that try to protect jobs and wages through import barriers or restrictions on offshoring will only hasten their relative decline. The challenge for governments in advanced economies is to find ways to spread the benefits of globalisation more fairly without reducing the size of those gains.

The high share of profits and low share of wages in national income are not the only numbers that have strayed a long way from their historical average. An alarming number of economic variables are currently way out of line with what conventional economic models would predict. America's current-account deficit is at a record high, yet the dollar has remained relatively strong. Global interest rates are still historically low, despite strong growth and heavy government borrowing. Oil prices have tripled since 2002, yet global growth remains robust and inflation, though rising, is still relatively low. House prices, however, have been soaring in many countries.

Puzzling it out

This survey will argue that all of these puzzles can be explained by the growing impact of emerging economies. For instance, low bond yields and the dollar's refusal to plunge are partly due to the way these countries have been piling up foreign reserves. Likewise, higher oil prices have mostly been caused by strong demand from developing countries rather than by an interruption of supply, so they have done less harm to global growth than in the past. And their impact on inflation has been offset by falling prices of goods exported by emerging economies. This has also made it easier for central banks to achieve their inflation goals with much lower interest rates than in the past.

All this will require some radical new thinking about economic policy. Governments may need to harness the tax and benefit system to compensate some workers who lose from globalisation.

Monetary policy also needs to be revamped. Central bankers like to take the credit for the defeat of inflation, but emerging economies have given them a big helping hand, both by pushing down the prices of many goods and by restraining wages in developed countries. This has allowed central banks to hold interest rates at historically low levels. But they have misunderstood the monetary-policy implications of a positive supply shock. By keeping interest rates too low, they have allowed a build-up of excess liquidity which has flowed into the prices of assets such as homes, rather than into traditional inflation. They have encouraged too much borrowing and too little saving. In America the overall result has been to widen the current-account deficit.

The central banks' mistake has been compounded by the emerging economies' refusal to allow their exchange rates to rise, piling up foreign-exchange reserves instead. Bizarrely, by financing America's

deficit, poor countries are subsidising the world's richest consumers. The opening up of emerging economies has thus not only provided a supply of cheap labour to the world, it has also offered an increased supply of cheap capital. But this survey will argue that the developing countries will not be prepared to go on financing America's massive current-account deficit for much longer.

At some point, therefore, America's cost of capital could rise sharply. There is a risk that the American economy will face a sharp financial shock and a recession, or an extended period of sluggish growth. This will slow growth in the rest of the world economy. But America is less important as a locomotive for global growth than it used to be, thanks to the greater vigour of emerging economies. America's total imports from the rest of the world last year amounted to only 4% of world GDP. The greater risk to the world economy is that a recession and falling house prices would add to Americans' existing concerns about stagnant real wages, creating more support for protectionism. That would be bad both for the old rich countries and the new emerging stars.

But regardless of how the developed world responds to the emerging giants, their economic power will go on growing. The rich world has yet to feel the full heat from this new revolution.

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A question of definition

Sep 14th 2006
From The Economist print edition

The borderline between rich and poor has become more fluid

WHAT determines whether an economy is “developed” or “developing”? Economies used to be categorised as developed if they were members of the Organisation for Economic Co-operation and Development (OECD), the so-called “rich-man's club”. But today the OECD is something of a mixed bag. It includes poorer countries such as Mexico and Poland, yet excludes places such as Hong Kong, Singapore and the UAE, which have GDPs per person similar to Italy's.

To add to the confusion, different organisations use different definitions. For instance, JPMorgan Chase and the United Nations count Hong Kong, Singapore, South Korea and Taiwan as emerging economies. Morgan Stanley Capital International includes South Korea and Taiwan in its emerging-market index, but keeps Hong Kong and Singapore in its developed-markets index. The IMF schizophrenically counts all four as “developing” in its International Financial Statistics but as “advanced economies” in its World Economic Outlook.

This survey will use the pre-1994 OECD membership as its definition of the developed world, and lump the rest—including Mexico, Poland, Hong Kong and so on—together as emerging economies. This is because its main objective is to assess the impact of the faster-growing developing world on the old rich world. The terms developing, third and poor world will be used interchangeably to refer to emerging economies, even though many of them are well on their way to joining the developed world.

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Emerging at last

Sep 14th 2006
From The Economist print edition

Developing economies are having a good run

IN 1994 this newspaper launched a new emerging-market indicators page to mark “a fundamental and remarkably rapid change in the balance of the world economy”. Emerging economies were then growing twice as fast as the rich ones, and their stockmarkets were surging. But the timing of the launch was awful. It came at the start of a dismal decade for emerging economies, with crises in Mexico at the end of 1994, Asia in 1997, Russia in 1998, Brazil in 1999, Turkey in 2000, Argentina in 2001 and Venezuela in 2002. By 2002 the MSCI emerging-market share-price index had lost almost 60% of its 1994 value. Last year it regained that peak. But is the current economic boom any more sustainable?

The 25% drop in emerging stockmarkets during May and June of this year was a warning. Having tripled over the previous three years, share prices, fuelled by excessive global liquidity, had got ahead of themselves and a correction was overdue. However, the economies themselves look in better shape than for decades. Over the past five years GDP per head in the emerging economies has grown by an annual average of 5.6%, compared with only 1.9% in the developed world. In the preceding 20 years GDP per head in poor countries had been growing by an average of 2.5%, little more than in rich economies.

Deep and crisp and even

In the past, as some economies sprinted, others stumbled. Today rapid growth is more evenly spread. This year, for the third year running, all of the 32 biggest emerging economies tracked weekly by *The Economist* are showing positive growth. In every previous year since the 1970s at least one emerging economy, often several, suffered a recession, if not a severe financial crisis.

Even Africa's prospects look brighter than they have done for many years. In the last quarter of the 20th

century real income per person in the world's poorest region stagnated, but so far this decade Africa has put on a spurt, with GDP growth above 5% for three consecutive years, thanks largely to higher commodity prices.

Developing countries have also benefited from America's consumer-spending binge, which has sucked in imports; and from historically low global interest rates, which have lowered debt-service costs. But favourable external factors played only a minor part in the revival of emerging economies. Much more importantly, their underlying economic health has improved. Structural reforms and sounder macroeconomic policies have made them more able to sustain robust growth and to withstand adverse shocks. Inflation has been tamed and many countries have trimmed their budget deficits; indeed, on average they are running much smaller deficits than the rich world.

Emerging economies are also much less dependent on foreign capital than they were a decade ago, leaving them less vulnerable to the whims of investors. As a group, they are in their eighth year of current-account surplus, having been in deficit for most of the previous 20. Their average ratio of foreign debt to exports has tumbled from 174% in 1998 to an estimated 75% this year. Foreign-exchange reserves have swollen to nine months' import cover, compared with only five months' just before the Asian crisis in 1997. And most emerging economies no longer fix their currencies at the grossly overvalued rates that contributed to past financial crises. If anything, the currencies of China and some other Asian countries are now undervalued.

Over the past few years all regions have enjoyed brisker growth, but some are in better shape than others. Emerging European economies have the least healthy external balances. Hungary and Turkey have current-account deficits of 7-8% of GDP. When investors dumped emerging-market assets in May and June of this year, these countries were hit hardest.

Emerging economies still face many potential risks, from banking crises to unrest in response to widening income inequality. Some could be badly hurt by a slump in demand in America or China and a consequent fall in commodity prices. Stephen Roach of Morgan Stanley argues that the weakness of emerging economies is no longer their dependence on external finance, as in the 1990s, but their dependence on external demand.

Just like America during its take-off in the late 19th century, emerging economies tend to be subject to economic ups and downs. But what matters most for their long-term prospects are their economic policies. They need to take advantage of the present period of strong growth to push ahead with reforms. Governments that still have large budget deficits, notably in central and eastern Europe, must wield the axe. Others, such as China, need to clean up their banking systems. Almost everywhere, governments can do more to free up markets and reduce their own meddling. In Asia, that includes allowing greater exchange-rate flexibility.

Rich economies can grow only by inventing new technology or management methods. Poor countries, in theory, should find it easy to grow faster because they can boost their productivity by adopting innovations from richer ones. In the past, such opportunities were all too often squandered through bad policies. But if structural reforms continue, there is huge future potential for growth.

Alwyn Young, an American economist, caused a stir in the mid-1990s (just before the East Asian crisis) by suggesting that East Asia's growth miracle was a myth. He calculated that most of the region's faster growth was due to increased inputs of labour and capital rather than to total factor productivity growth (the efficiency with which inputs of both capital and labour are used). Paul Krugman, another American economist, summed up Mr Young's discovery thus: “The miracle turns out to have been based on perspiration rather than inspiration.”

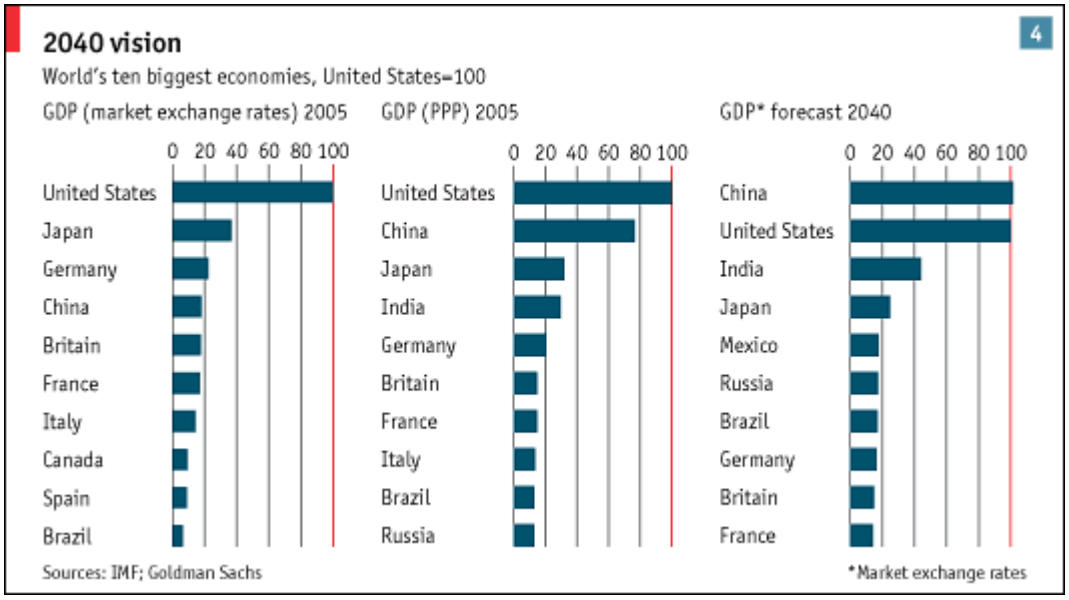
In fact, Mr Young underestimated the growth in total factor productivity in the Asian tiger countries, which had actually been considerably faster than in rich economies. Moreover, developing economies do not need inspiration to catch up. In the early stages of development, it is enough to maintain high rates of investment and copy techniques that have proved successful elsewhere. Asia worked its “miracle” by creating the right conditions for high investment: a high saving rate, open markets and a good education system.

Today, China's critics similarly argue that its growth has been driven largely by wasteful investment and cannot be sustained. In fact, total factor productivity growth in China has been even faster than in the rest of Asia. Over the past quarter-century it has averaged 3% a year, accounting for roughly the same amount of GDP growth as capital investment. (Over the same period, America's total factor productivity

grew by an annual average of only 1%.) Growth will slow as China's capital-to-output ratio rises toward rich-country levels and its excess labour dries up, but the country should still have a couple more decades of rapid growth in it.

A race that all can win

People love to argue about whether China or India will win the economic race, yet both can prosper together. China scores higher than India on many of the key ingredients of growth: it is more open to trade and investment, has a better record of macroeconomic stability and has put more effort into education and infrastructure. It is perhaps 10-15 years ahead of India in its economic reforms. However, in the long run India might pull ahead because its population will continue to grow long after China's has levelled off. Forecasters say that by 2030 it is likely to have more people than China.



Brazil, Russia, India and China are the four biggest emerging economies, grouped together under the acronym BRICs, created by Goldman Sachs in 2001. These four economies account for two-fifths of the total GDP of all emerging economies. China and India are generally seen as the two giants among them. This is true in purchasing-power-parity terms, but in current dollars Brazil and Russia both produce more than India. At market exchange rates, only China and Brazil rank among the world's top ten economies, but in purchasing-power terms all four BRICs make it.

Goldman's economists predict that if governments stick to policies that support growth, by 2040 China will be the world's biggest economy at market exchange rates. By then there will be five emerging economies in the top ten: the four BRICs plus Mexico (see chart 4). Together, they will be bigger in dollar terms than the G7 economies.

These forecasts assume, realistically, that growth in the BRICs will slow significantly by the end of the period. About one-third of the projected increase in the dollar value of the BRICs' GDPs comes from real currency appreciation rather than real growth. As countries' relative productivity rises, their exchange rates should move closer to purchasing-power parity.

However impressive, the forecasts still leave income per head in the BRICs well below those in developed countries. In 2040 the average American will still be three to four times richer than the average Chinese. Faster growth will not automatically end third-world poverty; that depends on how the fruits of growth are shared. But faster growth will make this goal more achievable. And as they move towards it, these economies will leave an ever larger footprint on the globe.

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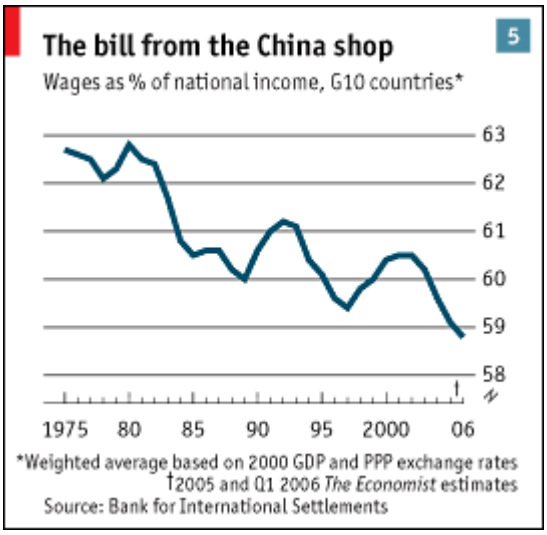
More pain than gain

Sep 14th 2006
From The Economist print edition

Many workers are missing out on the rewards of globalisation



RICH countries have democratic governments, so continued support for globalisation will depend on how prosperous the average worker feels. Yet workers' share of the cake in rich countries is now the smallest it has been for at least three decades (see chart 5). In many countries average real wages are flat or even falling.

Meanwhile, capitalists have rarely had it so good. In America, Japan and the euro area, profits as a share of GDP are at or near all-time highs (see chart 6). Corporate America has increased its share of national income from 7% in mid-2001 to 13% this year.

Like so many other current economic puzzles, the redistribution of income from labour to capital can be largely explained by the entry of China, India and other emerging economies into world markets. Globalisation has lifted profits relative to wages in several ways. First, offshoring to low-wage countries has reduced firms' costs. Second, employers' ability to shift production, whether or not they take advantage of it, has curbed the bargaining power of workers in rich countries. In Germany, for example, several big firms have negotiated pay cuts with their workers to avoid moving production to central Europe. And third, increased immigration has depressed wages in sectors such as catering, farming and construction.

Most of the fears about emerging economies focus on jobs being lost to low-cost foreign competitors. But the real threat is to wages, not jobs. In the long run, trade and offshoring should have little effect on total employment in rich countries; rather, they will change its composition. So long as labour markets are flexible, job losses in manufacturing should eventually be offset by new jobs elsewhere. But trade with emerging economies can have a big impact on both average and relative wages.

Over long periods of time, real wages tend to track average productivity growth. But so far this decade, workers' real pay in many developed economies has increased more slowly than labour productivity. The real weekly wage of a typical American worker in the middle of the income distribution has fallen by 4% since the start of the recovery in 2001. Over the same period labour productivity has risen by 15%. Even after allowing for health and pension benefits, total compensation has risen by only 1.5% in real terms. Real wages in Germany and Japan have also been flat or falling. Thus the usual argument in favour of globalisation—that it will make most workers better off, with only a few low-skilled ones losing out—has not so far been borne out by the facts. Most workers are being squeezed.

If GDP per person is growing fairly briskly, why are most workers missing out on real pay rises? Partly because a bigger share is going to profits, and partly because high earners have pocketed a huge slice of the gains in income, causing inequality to widen. America's top 1% of earners now receive 16% of all income, up from 8% in 1980. Wage inequality in Europe and Japan has also increased, but not by as much.

A decade ago, the consensus among economists was that increasing wage inequality was caused mainly not by trade but by information technology, which has raised the demand for skilled workers relative to unskilled ones. Today, a growing

number of economists agree that trade is playing a bigger role. It is hard to separate the impact of globalisation and IT on relative wages because they both reduce the demand for low-skilled workers. But now that the majority of workers are losing out, the finger of blame points at globalisation.

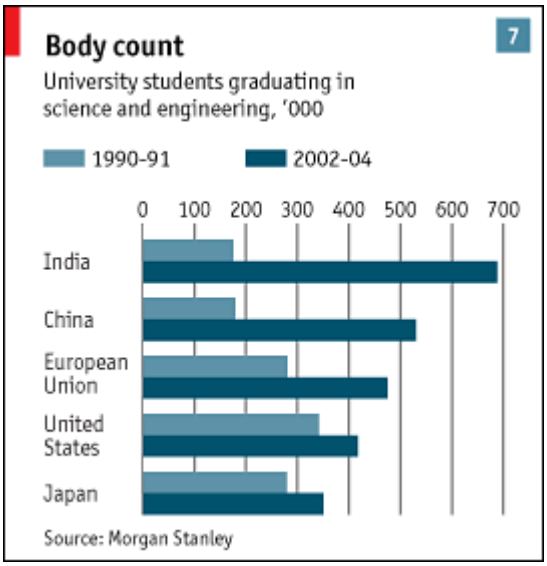
It's all comparative

Traditional trade theory, based on the ideas of David Ricardo, a 19th-century economist, argues that economies gain from trade by specialising in products where they have a comparative advantage. Developed economies have lots of skilled workers, whereas emerging economies have lots of low-skilled ones, so according to the theory advanced countries will specialise in capital-intensive products requiring skilled labour and emerging economies in low-tech products. Competition from cheaper imports will reduce the wages of unskilled workers in developed economies, but workers as a whole will be better off.

Yet, according to the evidence above, the average worker does not seem to be enjoying his fair share of the fruits of economic prosperity. Richard Freeman, an economist at Harvard University, points to several reasons why the traditional theory may need modifying. The first is that the sheer size of the emerging giants' labour forces has shifted the global capital-labour ratio (which determines the relative rewards of capital and workers) massively against workers as a group. The entry of China, India and the former Soviet Union into market capitalism has, in effect, doubled the world supply of workers, from 1.5 billion to 3 billion. These new entrants brought little capital with them, so the global capital-labour ratio dropped sharply. According to economic theory, this should reduce the relative price of labour and raise the global return to capital—which is exactly what has happened.

Over time, competition should reduce profit margins and distribute benefits back to consumers and workers in the form of lower prices. But downward pressure on wages in rich countries could continue for a long time. China still has perhaps 200m underemployed rural workers who could move to factories over the next two decades, so wages for low-skilled workers are rising more slowly than productivity, reducing China's unit labour costs.

A second reason why the traditional trade model needs modifying has to do with a rise in emerging countries' skill levels. It used to be thought that only rich countries had educated workforces able to produce skill-intensive goods, but poor countries have invested heavily in education in recent years, allowing them to start competing in more sophisticated markets. Every year, 1.2m engineers and scientists graduate from Chinese and Indian universities, as many as in America, the European Union and Japan combined and three times the number ten years ago (see chart 7). In 1970 America accounted for 30% of all university enrolments worldwide; now its share is down to around 12%.



The McKinsey Global Institute estimates that only one-tenth of engineering graduates in China and one-quarter in India would meet the standards expected by big American firms. But this will improve over time. A report by the World Bank also points out that a large share of engineering graduates in China and India become civil and electrical engineers, needed for the boom in domestic construction. There are not enough engineers and scientists to produce high-tech goods across the board. But it remains true that there has been a big increase in the global supply of educated as well as unskilled workers.

A third flaw in the traditional trade model, says Mr Freeman, is its assumption that rich countries would make high-tech products and developing economies low-tech ones. In fact, rich countries no longer have a monopoly on high-tech capital and know-how. The OECD says that in 2004 China overtook America as the world's leading exporter of information-technology goods. This exaggerates China's move up the ladder: laptop computers, mobile phones and DVD players are

no longer cutting-edge technology, and they are typically only assembled in China by foreign firms, with most of their high-value components being imported. Even so, the faster spread of technology to poor countries is weakening the rich world's comparative advantage in high-tech sectors. As emerging economies start to export high-tech goods and services, this reduces the prices of such products in world markets, and hence the wages of skilled workers in the developed world.

White-collar blues

It is no longer just dirty blue-collar jobs in manufacturing that are being sucked offshore but also white-collar service jobs, which used to be considered safe from foreign competition. Telecoms charges have tumbled, allowing workers in far-flung locations to be connected cheaply to customers in the developed world. This has made it possible to offshore services that were once non-tradable. Morgan Stanley's Mr Roach has been drawing attention to the fact that the “global labour arbitrage” is moving rapidly to the better kinds of jobs. It is no longer just basic data processing and call centres that are being outsourced to low-wage countries, but also software programming, medical diagnostics, engineering design, law, accounting, finance and business consulting. These can now be delivered electronically from anywhere in the world, exposing skilled white-collar workers to greater competition.

The standard retort to such arguments is that outsourcing abroad is too small to matter much. So far fewer than 1m American service-sector jobs have been lost to offshoring. Forrester Research forecasts that by 2015 a total of 3.4m jobs in services will have moved abroad, but that is tiny compared with the 30m jobs destroyed and created in America every year. The trouble is that such studies allow only for the sorts of jobs that are already being offshored, when in reality the proportion of jobs that can be moved will rise as IT advances and education improves in emerging economies.

Alan Blinder, an economist at Princeton University, believes that most economists are underestimating the disruptive effects of offshoring, and that in future two to three times as many service jobs will be susceptible to offshoring as in manufacturing. This would imply that at least 30% of all jobs might be at risk. In practice the number of jobs offshored to China or India is likely to remain fairly modest. Even so, the mere threat that they could be shifted will depress wages.

Moreover, says Mr Blinder, education offers no protection. Highly skilled accountants, radiologists or computer programmers now have to compete with electronically delivered competition from abroad, whereas humble taxi drivers, janitors and crane operators remain safe from offshoring. This may help to explain why the real median wage of American graduates has fallen by 6% since 2000, a bigger decline than in average wages.

In the 1980s and early 1990s, the pay gap between low-paid, low-skilled workers and high-paid, high-skilled workers widened significantly. But since then, according to a study by David Autor, Lawrence Katz and Melissa Kearney, in America, Britain and Germany workers at the bottom as well as at the top have

done better than those in the middle-income group. Office cleaning cannot be done by workers in India. It is the easily standardised skilled jobs in the middle, such as accounting, that are now being squeezed hardest. A study by Bradford Jensen and Lori Kletzer, at the Institute for International Economics in Washington, DC, confirms that workers in tradable services that are exposed to foreign competition tend to be more skilled than workers in non-tradable services and tradable manufacturing industries.

Ride on, Ricardo

None of this makes a case for protectionism. Offshoring, like trade, is beneficial to developed economies as a whole. The increased mobility of capital and technology does not invalidate the theory of comparative advantage, as some commentators like to argue. China and India cannot have a comparative advantage in everything; they will export some things and import others. Emerging economies' comparative advantage will largely remain in labour-intensive industries. A country's trading pattern is determined by its relative capital intensity compared with other economies. Emerging economies still have relatively little capital, so they are unlikely to become significant capital-intensive exporters until their capital-to-labour ratio catches up. That will take time. Developed economies will retain their comparative advantage in knowledge-intensive activities because they have relatively more skilled labour, but that advantage will be eroded more quickly in future.

The developed economies as a whole will still benefit hugely from trade with emerging economies. Increased competition and greater economies of scale will boost the growth in productivity and output. Consumers will enjoy lower prices and a greater variety of products, and shareholders will enjoy higher returns on capital. Although workers will continue to see their pay squeezed, they can still gain as consumers or as shareholders, either directly or through their pensions. The snag is that richer people own more shares, so the increased return on capital tends to reinforce income inequality.

In recent years the stagnation of real wages in America has been masked by surging house prices, which make families feel better off. If the housing market stumbles and the growth in pay remains feeble, there will be increased calls for the introduction of import barriers, restrictions on overseas investment and higher taxes on profits. But in a globalised economy, such measures would be worse than useless. Firms would simply move their head offices to friendlier countries.

The fact that many workers seem to be excluded from the spoils of globalisation is a big challenge to orthodox economics. Many of its practitioners refuse to come clean about the costs to workers of trade with emerging economies for fear of handing ammunition to protectionists. At the same time, protectionists exaggerate those costs and ignore the benefits. It is time for a more honest debate about trade.

Heading off the political backlash

A study by the Institute for International Economics estimates that globalisation is benefiting America's economy by $1 trillion a year, equivalent to $9,000 a year for every family. But in practice the average family has not seen such a gain because much of it has gone to those at the top or into profits. This explains the lack of support for globalisation from ordinary people. Unless a solution is found to sluggish real wages and rising inequality, there is a serious risk of a protectionist backlash. Rather than block change, governments need to ease the pain it inflicts in various ways: with a temporary social safety-net for those who lose their jobs; better education to equip workers for tomorrow's jobs; and more flexible labour markets to encourage the creation of new jobs.

More controversially, governments may need to redistribute the benefits of globalisation more fairly through the tax and benefits system. Studies suggest that countries with more generous social welfare policies are less likely to support protectionism. For instance, one reason why opposition to offshoring in Europe is less vocal than in America is that European health-care systems tend to be independent of employment, whereas in America losing your job means losing your health insurance too. In a riskier labour market, there may be a stronger case for health care to be financed by the state rather than by firms. Tax redistribution does not mean a return to taxing high earners at 70-80%, which would blunt economic incentives. Instead, scrapping tax breaks such as those given to home-buyers could make the tax system more progressive.

It is often argued that generous social-insurance and redistribution policies are inconsistent with globalisation because in an open world governments cannot raise taxes and spending in isolation. But if

real wages continue to stagnate and no compensation is forthcoming, political support for globalisation may fade and the vast gains from the biggest economic stimulus in world history will be lost.

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More of everything

Sep 14th 2006
From The Economist print edition

Does the world have enough resources to meet the growing needs of the emerging economies?

THE average income of the 5.5 billion people on this planet who live in emerging economies has been growing at a cracking pace: an annual rate of over 5% in recent years. As people grow richer, they want more cars and household appliances as well as better homes and roads. This, in turn, means a huge increase in the demand for energy and raw materials.

Emerging economies already account for over half of the world's total energy consumption. Since 2000 they have been responsible for 85% of the increase in world energy demand. China alone accounted for one-third of the increase in world oil consumption. The developing world's demand for industrial raw materials is also rising rapidly. China's share of world metal consumption has jumped from less than 10% to around 25% over the past decade. In the three years to 2005 the country accounted for 50% of the increase in world consumption of copper and aluminium, almost all the growth in nickel and tin and more than the entire rise in demand for zinc and lead (which means the rest of the world consumed less of them).

Some of the extra demand in China reflects a shift in production from other parts of the globe, but most of it is a net boost to global demand. Since 2000 world energy consumption has been increasing at an annual average of 2.6%, twice as fast as in the previous decade. Yet China and other emerging economies have only just begun to make an impact on commodity markets. Given the size of their populations, their use of raw materials is still modest. For instance, China uses only one-third as much copper per person as does America. Its oil consumption per person is only one-thirteenth that of America (see chart 8).

China's current demand for raw materials per person is roughly at the stage of Japan's and South Korea's during their respective economic take-off. If China follows a similar path to South Korea's as its income rises, then its total oil consumption could increase tenfold in absolute terms over the next three decades, and yet it would still be using 30% less oil per person than the United States does today.

Currently about 90% of China's energy is produced at home, but in future the country will need to import much more of it. A study by Deutsche Bank predicts that its oil imports will jump from 91m tonnes to 1,860m tonnes by 2020. The bank also reckons that copper imports will rise from 3m tonnes to 20m tonnes. No wonder China is forging close trade links with commodity producers in Africa, the Middle East, Australia and Latin America.

Rising demand in emerging economies has caused oil and commodity prices to surge in recent years. The prices of both oil and metals have roughly tripled since 2002. This has been good for commodity producers, most of which are developing economies. The past few years have seen the sharpest rise in commodity prices in modern history, with metal prices in real terms gaining twice as much as in the booms of the 1970s and 1980s.

Previous commodity booms have always been followed by slumps. Indeed, the long-term trend in commodity prices has been firmly downwards. Even with the recent rise, prices in real terms are less than half of what they were in the mid-19th century (see chart 9). The shift in developed countries' output from metal-bashing industries to services has curbed demand, as have technological advances that have provided substitutes, such as fibre optics instead of copper wire. Better technology has also improved rates of mineral extraction, increasing supply.

Different this time?

However, some analysts claim that the world is now in the middle of a “super-cycle”, fuelled by soaring demand in emerging economies, which will keep prices high for the foreseeable future. Demand from emerging economies continues to grow strongly and supply remains tight, so the equilibrium price of raw materials does appear to have increased. But other experts argue that this is a speculative bubble and prices are unsustainable. According to Simon Hayley, an economist at Capital Economics, many analysts make the mistake of extrapolating from the recent rate of growth in demand and underestimating the potential for increasing supply.

Farm output can be increased most quickly; stepping up oil production takes the longest. Higher oil prices will encourage more investment and production, but it can take up to seven years for new projects to come on stream. Meanwhile, higher prices help to curb demand by encouraging a switch to alternative fuels and changes in consumer behaviour, such as buying more fuel-efficient cars. Capital Economics expects the oil price to fall to $50 a barrel by the end of 2007 from its current level of $70, but other analysts expect it to stay above $60 for several years. And strong demand with little or no spare capacity means a high risk of price spikes if supply is disrupted.

Prices of commodities other than oil are more likely to fall because supply and demand are more responsive to price. Reserves of metals are vast. According to Mr Hayley, total deposits of copper (inferred from geological evidence) would last 107 years and of iron ore 151 years at current rates of consumption. These deposits may not all be profitable to extract with current technology, but high prices will encourage technological advances. A study by Martin Sommer, an economist at the IMF, finds that copper prices are currently almost three times above the cost of the least efficient producers, a much higher ratio than at the peak of the 1980s boom.

The problem is that years of low prices have caused underinvestment, and producers have been caught out by the jump in demand. But in the long term capacity should catch up and prices will fall. Global spending on exploration for non-ferrous metals rose to $5 billion in 2005, from $1.9 billion in 2002. High prices are also encouraging users to look for alternatives.

Commodity bulls argue that China has reached the most commodity-intensive stage of its development: industrialisation, urbanisation and infrastructure all use lots of raw materials. If China's growth remained as commodity- and energy-intensive as at present, supply would struggle to catch up and there could indeed be further upward pressure on prices. However, the country's investment boom cannot continue at its current pace. The government aims to shift the balance of growth from exports and investment

towards private consumption, which implies slower growth in the demand for raw materials. The Chinese leadership has also announced a target of a 20% cut in energy use per unit of GDP by 2010.

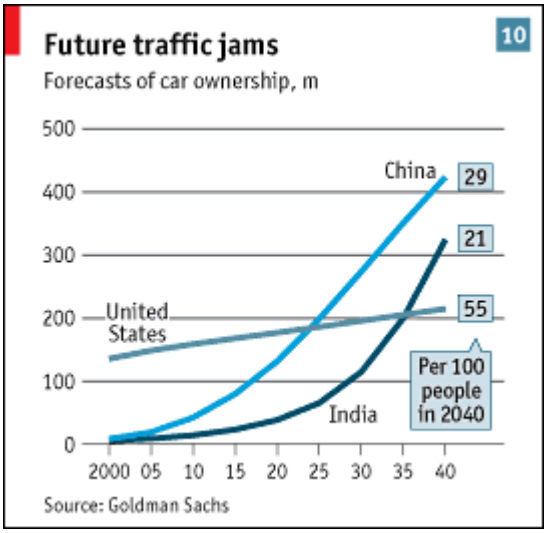
The risk is that new supplies of commodities will come on stream just as global demand starts to slow, causing prices to drop sharply. The commodity boom may anyway have been exaggerated by speculation as new investors piled into the market. However, an analysis by the IMF suggests that speculative investment has had much less effect on metal prices than it has on oil prices.

Mr Sommer's study, using a model that estimates both future demand and future supply, forecasts that by 2010 prices of copper and aluminium in real terms will fall by 53% and 29% respectively as supply increases. This is broadly in line with prices in the futures market, which signal a 44% average fall in metal prices in real terms over the next five years, whereas oil futures are close to the current spot price.

Such a drop would still leave metal prices well above their level at the start of this decade, in contrast to previous booms after which price rises were always fully reversed. This is because global demand is likely to continue to grow much faster than it has done in the past. Even if the growth in China's demand for commodities slows in future, it will remain faster than in rich economies. Because of the country's increasing weight in the world economy, this will keep up global demand.

Moreover, as China's demand for raw materials slows, India's is likely to take off. India currently consumes only one-eighth as much copper and one-third as much energy per person as does China. India's export growth has been led by business and IT services, which use fewer raw materials. But India needs to expand its manufacturing to create more jobs, and to improve its dreadful infrastructure. UBS reckons that India's raw-material demand will triple over the next ten years as capital expenditure and infrastructure spending increase.

A study by Ting Gao, Cameron Odgers and Jiming Ha, at China International Capital Corporation, forecasts that annual growth in China's demand for copper will slow from an average of 14% over the past 15 years to 9% between 2006 and 2020, whereas India's will accelerate from 7% to 20% over the same period. Even if demand in the rest of the world continued to grow at the same pace as before, this would lift the annual rate of growth in global demand for copper from 3.5% between 1990 and 2005 to 5.3% over the next 15 years. For other commodities, too, the growth in global demand is forecast to speed up, even as growth in China slows down. The authors conclude that commodity prices will remain historically high.



Over the next few decades, one of the main determinants of increased oil demand will be higher car ownership in emerging economies. At present there are only two cars for every 100 people in China, against 50 in America. Goldman Sachs forecasts that China's car ownership will rise to 29 per 100 by 2040. The total number of cars in China and India combined could rise from around 30m today to 750m by 2040 (see chart 10)—more than all the cars on the world's roads today. Even so, car-ownership rates in those two countries would still be only half those in America today.

Keep it green

Many people worry more about the environmental damage resulting from emerging countries' rising energy demand than they do about rising prices. Rapid industrialisation has already caused an alarming increase in emissions of greenhouse gases and air pollution. China has 16 of the world's 20 most air-polluted cities. America is still the world's largest spewer of carbon emissions, but China is expected to overtake it within a decade or so. A report by Zmarak Shalizi, an economist at the World Bank, forecasts that on current policies carbon emissions in China and India will more than double by 2020—though that would still leave China's carbon emissions per person at only one-third of the current level in America.

The world does not have the resources for another 5 billion or so people to behave the way that Americans do today. It may not be about to run out of energy and commodities, but higher prices will certainly force big changes in lifestyles. The era of cheap raw materials is over.

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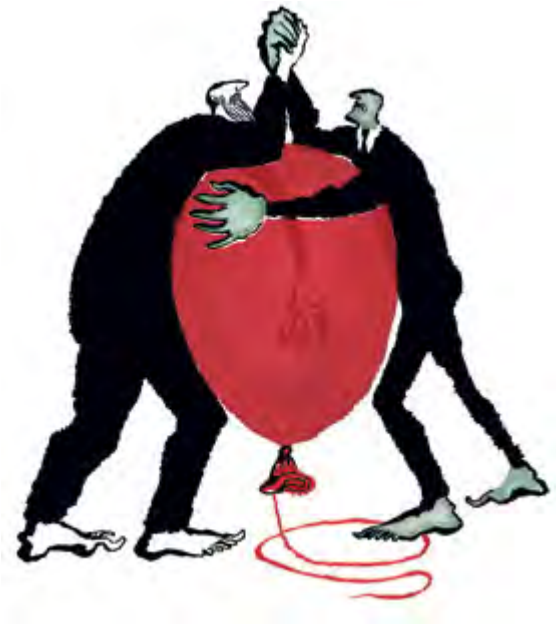
Weapons of mass disinflation

Sep 14th 2006
From The Economist print edition



Competition from emerging economies has helped to hold inflation down

INFLATION worldwide has been unusually subdued in recent years. Although in developed economies, notably America, it has been creeping up over the past year, it is still well below what most economic models would have predicted given strong growth, rising oil prices and easy monetary conditions. This is partly the result of better monetary policy, which has lowered inflationary expectations. But possibly a more important explanation is that globalisation has made central banks' job of holding down inflation much easier.

Monetary pedants will argue that in the long run inflation is determined by monetary policy. Globalisation can affect only relative prices. Thus China is pushing up commodity prices, but pulling down the cost of labour-intensive manufactured goods (see chart 11). If central bankers aim for a particular inflation target, then falling prices of consumer durables will be offset by rising prices elsewhere, leaving the inflation rate unchanged.

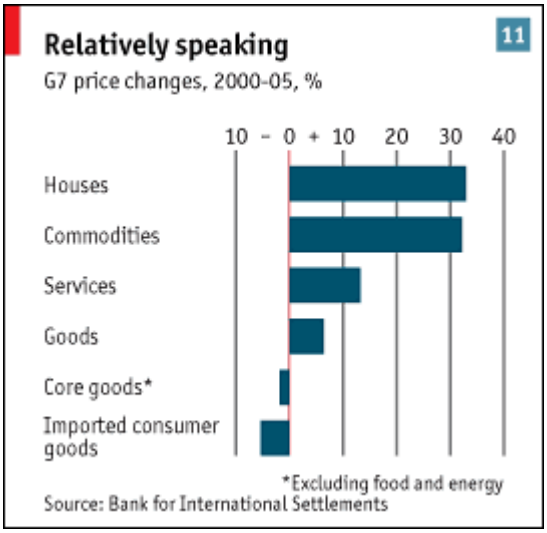
However, globalisation can make such targets easier to achieve, at lower interest rates than would otherwise be necessary. This can happen in several ways. Most obviously, the opening up of China, India and the former Soviet block has exerted downward pressure on inflation by increasing competition from these lower-cost producers. The average price of American imports from emerging Asia has fallen by over 25% since the mid-1990s.

The increase in the global labour force has also curbed workers' bargaining power, and hence wage costs. More generally, the expansion in global supply brought about by the emerging economies has reduced price pressures at any given rate of growth and so reduced the cost of fighting inflation. And by helping to tame inflation, globalisation may also have bolstered the credibility of central banks, thus reducing inflationary expectations. Last but not least, globalisation has reduced the sensitivity of inflation to changes in the amount of domestic economic slack.

A study by Claudio Borio and Andrew Filardo, two economists at the Bank for International Settlements, confirms that inflation rates in developed economies have become less sensitive to the domestic output gap (the difference between actual and

potential GDP), whereas global economic conditions have become more important. In a closed economy, when production outpaces potential output, inflation rises. In an open economy, an increase in demand can be met by imports, so it has less of an effect on inflation.

This makes a nonsense of traditional closed-economy models used to forecast inflation, which assume that firms set prices by adding a mark-up over unit costs, with the size of the margin depending on the amount of slack in the domestic economy. It also explains why inflation is still relatively low even though domestic capacity utilisation has been rising rapidly and unemployment has been falling in most developed economies: at a global level there is still ample economic slack.



Inflated claims?

Some economists question the link between globalisation and lower inflation. For example, a study in the IMF's April 2006 *World Economic Outlook* concludes that the decline in real import prices caused by globalisation has had little lasting effect on inflation rates. But this ignores the potentially larger indirect effects of increased international competition. Cheaper goods from China do not just reduce the prices of imports, but the prices of all goods sold in competing domestic markets. And competition from emerging economies holds down inflation not just in traded goods but also in non-traded ones, by restraining wages.

Don Kohn, vice-chairman of America's Federal Reserve, has also argued that the entry of China and India into the global trading system has probably had only a mild disinflationary effect. By running current-account surpluses, these economies are currently adding more to global supply than to demand, so their net effect on the rest of the world is disinflationary. But Mr Kohn points out that if their exchange rates rise and domestic demand increases, eliminating current-account surpluses, these effects could be reversed.

Still, even if emerging economies as a group were to run a current-account deficit, the increasing integration into the world economy of lower-cost producers would still continue to hold down wages and prices in a growing number of industries. So long as goods remain much cheaper in emerging economies, the rising market share of these countries will help to reduce inflation in the developed world. International trade in services is also likely to accelerate. The IMF calculates that if trade integration in business services were to reach the current levels in manufacturing, prices for these services would fall by 20% relative to average producer prices.

None of this means that globalisation has killed off inflation. Indeed, the rise in America's inflation rate over the past year, to over 4%, should have rung alarm bells much sooner. Central banks need to remain vigilant. Mr Kohn is right to point out that capacity constraints and hence inflationary pressures will eventually make themselves felt in the world economy, just as they always have done at national level.

Some commentators think that this is now beginning to happen. In recent months there has been a flurry of reports suggesting that China is running out of cheap labour, and that wages and export prices are rising. China, it is argued, is now exporting inflation, not deflation. Such concerns are hugely overblown. It is true that several cities have increased their minimum wage by an average of 20% this year, but many manufacturers were already paying above the minimum.

There have also been reports of labour shortages in China, but mainly for managers and skilled workers. The rapid pace of average wage growth is due to productivity gains rather than labour shortages. Average urban wages have been rising by more than 10% a year over the past decade, but productivity in manufacturing has been growing faster still, so unit labour costs have fallen. According to the *Bank Credit Analyst* they have continued to slide this year (see chart 12). China's productivity gains partly reflect a shift in the mix of its exports towards higher-value goods. In these new sectors the country is now driving global prices down, but the shift to more expensive products misleadingly makes it look as if export prices have stopped falling.

Arthur Kroeber of Dragonomics, a Beijing-based economic-research firm, dismisses the worries about

China exporting inflation. Chinese export prices did pick up in 2004-05, but they are now falling again. American import prices from Asia are also still falling. Moreover, he says, it is hard to see how China can be exporting inflation when it has overcapacity, thanks to excessive investment.

In any case, focusing on China's export prices alone tells only part of the story. As China increasingly penetrates world markets and provides competition for more workers in the developed world, the downward pressure on their wages will persist. It could take two more decades before China's surplus rural labour is fully absorbed by industry.

In a way, the debate about whether globalisation has reduced inflation misses the point. The real question is whether the opening up of the emerging economies has allowed central banks in rich countries to hold interest rates much lower while still meeting their inflation goals. This survey argues that it has, raising two questions. First, have low interest rates had undesirable side-effects? And second, what will happen when the cost of borrowing eventually returns to normal levels?

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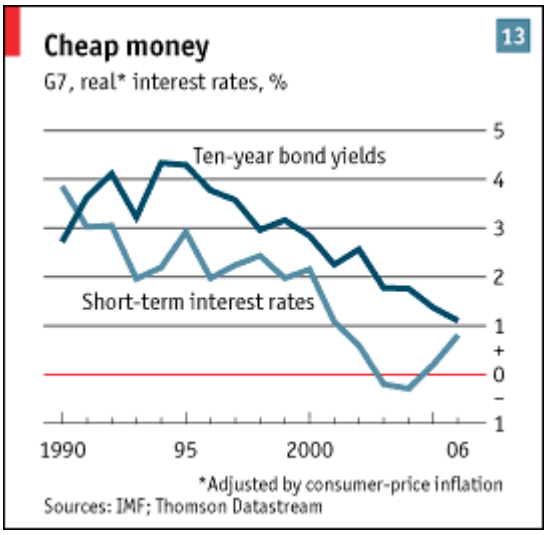
Unnatural causes of debt

Sep 14th 2006
From The Economist print edition

Interest rates are too low. Whose fault is that?

GLOBALISATION may have helped to hold down inflation, but it has also raised some new dilemmas for central banks. Most notably, should they cut interest rates to stop inflation falling below their usual target in response to a boost to global supply—which is how they would deal with falling inflation caused by a slump in demand—or should they accept a lower rate of inflation? Most central banks aim for an inflation rate of close to 2%, in the belief that too little inflation can be as harmful as too much of it.



Real interest rates in the past few years have remained lower for longer than at any other time during the past half-century. Despite recent tightening by central banks, average real short-term rates and bond yields in the developed economies are still well below normal levels (see chart 13). Most commentators have concluded that a new era of cheaper money has arrived.

Yet globalisation might have been expected to raise, not lower, the world's natural rate of interest (ie, the rate that is consistent with long-run price stability and also ensures that saving equals investment). In theory, the long-term real equilibrium interest rate should be equal to the marginal return on capital. And the opening up of emerging economies has increased the ratio of global labour to capital, raising the return on capital, so real interest rates should rise, not fall.

Another way to look at this is that real interest rates should be roughly the same as the trend rate of GDP growth (a proxy for the return on capital). If greater global economic and financial integration leads to a more efficient use of labour and capital, economic growth will be faster, which again means that real interest rates should rise. So why have they been so low?

Analysts have put forward two main explanations for the low level of real bond yields in recent years. The first is that high saving (in relation to investment) by Asian economies and Middle East oil exporters has caused a global saving glut, pushing down yields. These economies are running large current-account surpluses, and much of that money has been piled up in official reserves, particularly in American Treasury securities, as central banks have intervened in the foreign-exchange market to prevent their currencies from rising.

Of gluts and floods

Various estimates suggest that such foreign-exchange intervention reduced American yields by less than one percentage point in 2004-05. But Nouriel Roubini and Brad Setser of Roubini Global Economics reckon that the impact could be larger. Most studies ignore the fact that without official intervention by foreign central banks the dollar would be lower and hence American inflation higher, which would push bond yields higher. And if central banks were not buying dollars to prop up the currency, many private investors might hold fewer greenbacks, which again would push up yields. Adding up these and other factors, Messrs Roubini and Setser reckon that American Treasury bond yields would have been two percentage points higher in recent years if central banks in emerging economies had not bought dollar reserve assets.

A second explanation for low bond yields is that excess liquidity has pushed up the prices of all assets, including bonds. Over the past

few years, the global money supply has grown at its fastest pace since the 1980s. This excess liquidity has not pushed up conventional inflation (thanks largely to cheap Chinese goods), but has fed into a series of asset-price bubbles around the world.

Both developed and emerging economies have contributed to this flood of liquidity. Central banks in rich countries have held interest rates abnormally low to offset disinflationary pressures from emerging economies. At the same time, to prevent their currencies rising, emerging economies have also held interest rates low and engaged in heavy foreign-exchange intervention, which has inflated their money supplies.

Both of these explanations for low interest rates—the saving glut and the excess liquidity—involve emerging economies; either through their impact on developed economies' inflation and hence monetary policy, or through their foreign-exchange intervention. In that sense, global monetary conditions are increasingly being influenced by policies in Beijing as much as in Washington, DC. Over the past year, emerging economies have accounted for four-fifths of the growth in the world's monetary base.

Have central banks in developed economies been right to pursue lax monetary policies? For borrowers, low interest rates are an unmitigated blessing, but for economies as a whole the gap between interest rates and the long-run return on capital has created some serious economic and financial imbalances. Thanks to cheap money, American households are saving too little and borrowing and spending too much. At the same time bubbly house prices have soared to record levels in relation to incomes.

Bill White, chief economist at the Bank for International Settlements, suggests that central banks' inflation targets may be too high, given the big boost to global capacity from China's and India's re-emergence. If a negative supply shock (from higher oil prices, say) were to cause inflation to rise, most central banks would do nothing about it as long as it did not increase inflationary expectations and lead to second-round effects on other prices. The logic is that central banks should ignore price changes that they cannot control. To be consistent, says Mr White, central banks should also have tolerated the inflation-lowering impact of a positive supply shock from the emerging economies, allowing cheaper goods and wages to reduce inflation. Instead, in 2001-03 central banks prevented inflation from falling by pushing interest rates much lower than they would otherwise have been.

Ben Bernanke, the chairman of America's Federal Reserve, would argue that when the Fed slashed interest rates to 1% in 2003, it was trying to prevent harmful deflation. However, deflation need not be what it was in the 1930s, a vicious circle of deficient demand, falling prices and rising real debt. Historically, most deflations have been benign, caused by technological innovation or the opening up of economies (ie, positive supply shocks), and were accompanied by robust growth. During the rapid globalisation of the late 19th century, flat or falling average prices went hand in hand with strong growth in output. Today's world has much more in common with that period than with the 1930s.

Too much, too soon

With hindsight, the deflation that the Fed was fretting about in 2003 was largely benign, caused by cheaper goods from China and by the IT revolution. But the Fed was so determined to prevent deflation of any kind that it cut interest rates to unusually low levels. This, argues Mr White, could have long-term costs because persistently cheap money encouraged too much borrowing, too little saving and unsustainable asset prices. The risk is that if central banks lean against benign deflation, they will unwittingly accommodate a build-up of imbalances. Ironically, these could cause a bout of bad deflation as they unwind.

The problem is that most central banks base their policy analysis on Keynesian-style economic models in which deviations from their inflation goal are assumed to reflect excess or inadequate demand, requiring a change in monetary policy. But supply shocks such as globalisation can cause deviations in inflation

that require a completely different policy response. A more relevant model might be one based on the Austrian school of economics, developed in the late 19th century, when economic conditions were more akin to today's. In Austrian models the main result of excessively low interest rates is not inflation but overborrowing, an imbalance between saving and investment and a consequent misallocation of resources. That sounds like America today.

Mr White argues that if central banks focus solely on price stability, they might allow ever bigger financial imbalances to build up. This is why they need to watch a wider range of indicators beyond inflation, including the growth in credit, money, saving rates and asset prices. They should be prepared to raise interest rates in response to clear evidence of financial imbalance, says Mr White, even if it means they undershoot their inflation targets.

The other risk of holding interest rates too low for too long is that inflation will suddenly rise. This is what has now happened in America, where the inflation rate has risen above 4%, prompting the Fed to push interest rates higher this year. If the low bond yields were also largely due to excess liquidity, then rising short-term rates could push yields much higher than the markets expect. At some point rates will rise to their higher equilibrium level. The likely consequence is a severe weakening or a slump in housing markets around the globe and a sharp slowdown in consumer spending.

Central banks have been slow to grasp the fact that the rapid integration of emerging economies into the global market system requires them to rethink their monetary policy. If they fail to recognise benign deflation created by positive supply shocks, then excessively loose monetary policy will fuel not only financial bubbles but also bigger current-account imbalances—the subject of the next article.

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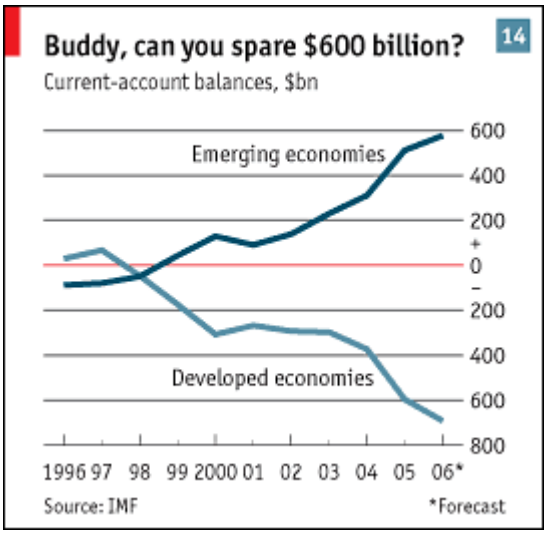
A topsy-turvy world

Sep 14th 2006
From The Economist print edition

How long will emerging economies continue to finance America's spendthrift habits?



MANY economists have long been expecting America's widening current-account deficit to cause a financial meltdown in the dollar and the bond market. The main reason why this has not happened (yet) is that emerging economies have been happy to finance that deficit. In 2005 this group of countries ran a combined current-account surplus of over $500 billion (see chart 14). A large chunk of that was invested in American Treasury securities, in what Ken Rogoff of Harvard University has called “the biggest foreign-aid programme in world history”.

The flow of capital from poor countries to the richest economy in the world is exactly the opposite of what economic theory would predict. According to the textbooks, capital should flow from rich countries with abundant capital, such as America, to poorer ones, such as China, where capital is relatively scarce, so returns are higher. This is what happened during the globalisation of the late 19th century, when surplus European saving financed the development of America. Between 1880 and 1914, Britain ran an average current-account surplus of 5% of GDP. In contrast, America today has a deficit of 7% of GDP. It seems perverse that poor countries today prefer to buy low-yielding American government bonds when they could earn higher returns by investing in their own economies.

So why are they doing it? One explanation is the so-called “Bretton Woods 2” thesis put forward three years ago by Michael Dooley, David Folkerts-Landau and Peter Garber at Deutsche Bank. (Bretton Woods was the system of fixed exchange rates that prevailed for a quarter of a century after the second world war.) They argue that Asian economies are pursuing a deliberate policy of currency undervaluation to ensure strong export-led growth. To hold their currencies down, Asian central banks have been buying lots of American Treasury bonds. This reduces interest rates and supports consumer spending in the United States, allowing Americans to buy lots more Asian exports—which, the authors argue, suits both Asia and America.

Furthermore, they say, opening its doors to foreign direct investment (FDI) has helped China to build a world-class capital stock. Emerging economies with poorly developed financial markets are not good at allocating capital, so they buy Treasury bonds and let American firms do the domestic investment for them. Admittedly the return on Treasury bonds is lower than the return on FDI, but this, the authors reckon, is a small price to pay for more efficient domestic investment and hence faster long-term growth.

The bottom line of this theory is that the main blame for America's deficit lies with Asia's emerging economies, rather than with America itself. And because the arrangement is in those Asian countries' economic interest, the theory suggests, they will go on financing America's deficit for a good many years.

Lost in the woods

However, Morris Goldstein and Nicholas Lardy, at the Institute for International Economics in Washington, DC, argue that Bretton Woods 2 does not explain China's behaviour in the past, and it certainly would not be in China's interest to go on behaving that way in future. The first flaw in the theory is that America takes only one-fifth of China's exports, with Europe a close runner-up. So if China were trying to keep the yuan undervalued, it would surely do better to hold down its real trade-weighted

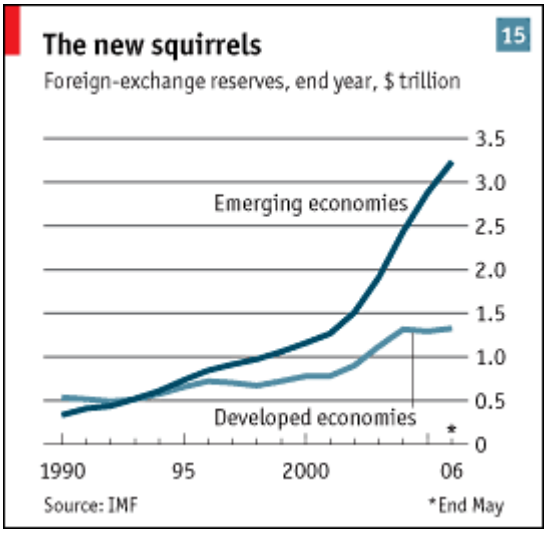
exchange rate, which rose by 35% during the dollar's climb from 1994 to 2001.

China's main motive for tying the yuan closely to the dollar has been financial stability, not crude mercantilism. But now a rigid exchange rate looks as though it might become a source of instability. The large build-up of reserves that has resulted from currency intervention is creating excess liquidity, with its attendant risks of inflation, asset-price bubbles and a serious misallocation of capital.

The dollar “peg” has forced China to adopt an excessively lax monetary policy. Real interest rates of 3% are far too low for an economy growing at 10%, but there is little room to raise rates because that would attract more inflows of short-term capital and so require even greater intervention, further boosting liquidity. China needs a more flexible exchange rate so it can regain control of its monetary policy.

Another reason why building up yet more reserves is not in the interest of Asian central banks is that it would expose them to large future losses when their currencies do eventually appreciate against the dollar. Emerging economies hold 70% of global foreign-exchange reserves (see chart 15), mainly in dollars, and account for four of the top five holders of reserves (China, South Korea, Taiwan and Russia). By the end of this year China's reserves are likely to reach $1 trillion. Messrs Roubini and Setser calculate that a 33% rise in the yuan—which is quite possible over several years—would imply a politically embarrassing capital loss of 15% of China's GDP. The longer that countries accumulate reserves, the bigger the potential losses.

A third defect in the Bretton Woods 2 theory, according to Messrs Goldstein and Lardy, is that in recent years FDI has financed less than 5% of China's fixed investment, clearly nowhere near enough to have helped create a world-class capital stock. The only way that China can ensure a better allocation of capital is by reforming its domestic financial system and by using higher interest rates to cool overinvestment. Again, that suggests it is now in China's own interest to allow more flexibility in its exchange rate, which means buying fewer Treasury bonds.



All this suggests that China now needs to set its currency free for the sake of its own economy, rather than America's. Indeed, a revaluation of the yuan by itself probably would not make much of a dent in America's current-account deficit, because it would not solve the structural imbalance between saving and investment. America has a huge deficit largely because it saves too little. Politicians, however, prefer to blame China.

The final nail in the coffin of Bretton Woods 2 is that the increase in China's external surplus has been much too small to account for America's deficit. Estimates for 2006 suggest that China's current-account surplus has widened by $140 billion since 1997, whereas America's deficit has expanded by $720 billion. By far the largest counterpart to America's deficit today is the group of emerging oil exporters, which have moved from rough balance in 1997 to an estimated surplus of $425 billion this year—much larger than emerging Asia's total surplus of $250 billion.

Oil exporters are determined not to repeat their mistakes after previous oil-price jumps. They have been much more cautious in spending their revenues, saving a larger share than in the past. So far, the bulk of petrodollars has probably gone into relatively liquid dollar assets. But these countries have greater reason than Asia to invest in non-dollar currencies, because they trade much less with America. And petrodollars are mostly managed by investment funds that aim to maximise returns, so oil exporters' assets are more footloose than those of Asian central banks and could quickly shift out of the dollar if it starts to slide again.

Too much of a good thing

Mr Bernanke has argued that America's deficit is the innocent by-product of a saving glut in emerging economies. If the rest of the world saves more than it invests (ie, runs a current-account surplus), then America has to run a deficit. The implication is that America's deficit is more sustainable than generally thought. But this still begs the question of why emerging economies have excess saving when their return on investment is higher than in rich countries.

A paper presented by Raghuram Rajan, chief economist of the IMF, at this year's annual symposium of the Federal Reserve Bank of Kansas City offers a tentative explanation. Mr Rajan argues that fast-growing poor countries tend to generate more saving than they can use because of their underdeveloped financial systems.

Thus when a country experiences rapid productivity growth, consumers save much of their income gains. But the opportunities for transferring those savings into domestic investment through the financial system are limited, so saving typically exceeds investment and the country runs a current-account surplus. This also explains the unexpected finding that emerging economies that rely least on foreign finance tend to enjoy the fastest growth. Faster-growing economies simply generate more domestic saving.

But this means that capital flows to the United States are sustainable only as long as emerging economies' domestic financial systems remain immature and unable to offer the usual range of financial instruments; and such shortcomings have a clear economic cost. In the years ahead, as these countries' domestic financial systems develop, their current-account surpluses are likely to disappear.

How long might that take? Consider China, the thriftiest of them all, which saves almost 50% of its annual GDP. Many people believe that this is because Chinese households need to maintain a large financial cushion to make up for the lack of a social safety net and the absence of consumer credit. However, Louis Kuijs, an economist at the World Bank, says that China's household saving rate, at 16% of GDP, is not abnormally high; in fact, it is lower than India's. What pushes the overall rate to such exalted levels is huge saving by companies and by the government. State firms do not pay dividends, so high profits in recent years have pushed up their saving. Government saving is also unusually high.

On the basis of current policies and expected changes in income and demographics, Mr Kuijs predicts that China's saving rate will fall only modestly over the coming years, still leaving a substantial current-account surplus in two decades' time. But if the government implements reforms, forcing firms to pay dividends, liberalising financial markets and spending more on health and education, then China's current account could be brought into rough balance by 2020, he says.

However, another World Bank paper, by David Dollar and Aart Kraay, suggests that China could be running sizeable deficits by then. The authors say that it does not make sense for China to be a large net supplier of capital to the rest of the world when its productivity is growing rapidly and its capital-labour ratio is only one-tenth of that in America. They put this distortion down mainly to extensive capital controls that prevent residents from borrowing abroad and foreigners from investing in China. If all capital controls were scrapped and the government pushed ahead with economic and financial reforms, China would run a current-account deficit of 2-5% of GDP, they reckon.

Capital-market reforms should also bring down net saving in other emerging economies. In other words, at some time in the future, emerging economies may no longer provide capital to the rest of the world, but instead run current-account deficits. This will increase the global cost of capital, especially in America.

But before that happens, emerging economies' investment in foreign assets is likely to change its composition, favouring corporate assets rather than low-yielding Treasury bonds. The snag is that American politicians are most reluctant to allow Chinese, Russian or Middle Eastern firms to have a

controlling interest in American firms: witness the failed attempt by China's CNOOC, a state-owned oil company, to buy Unocal last year, and Dubai Ports World's aborted takeover of several American ports this year. As long as America depends on foreign capital, it needs to be less picky.

The world's present external imbalances are neither desirable nor sustainable. Those who argue that poor countries will continue to finance America's current-account deficit long into the future seem to forget that one day it will have to pay back the money.

Nor are the current arrangements in the long-term interest of America's economy. By buying dollar assets, Asian central banks are subsidising American consumers, encouraging too little saving, too much spending and excessive investment in housing. Asia's central banks have turned off the usual market signal of rising bond yields which should be telling America to put its house in order. As long as America can get cheap money from abroad, it has little incentive to rebalance its economy.

When global imbalances are eventually unwound, the process will hurt even more. Unless America reduces its deficit before emerging economies lose interest in accumulating reserves, the dollar, Treasury bonds and the whole American economy are likely to suffer a hard landing.

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Playing leapfrog

Sep 14th 2006
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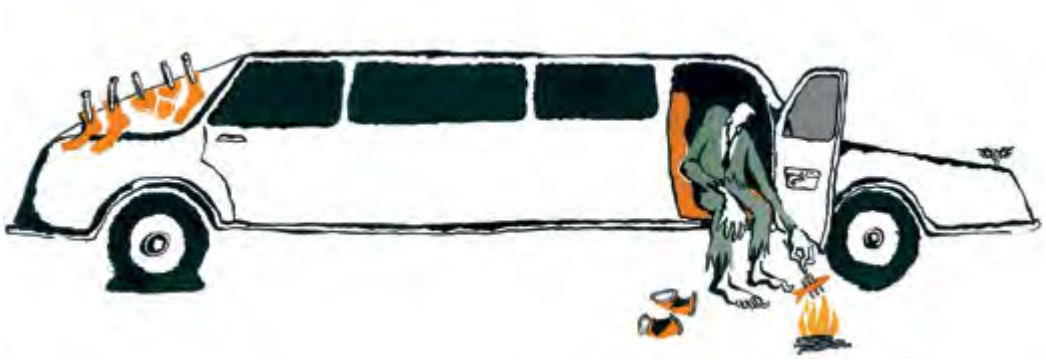

If today's rich world does not watch out, it could become tomorrow's relatively poor world

ALEXIS DE TOCQUEVILLE once observed that the French hate anybody who is superior, and the English like to have inferiors to look down upon. These two nations were long ago knocked off their pedestals. Now it is the Americans who fret about losing their economic supremacy. If China continues with its reforms, one day it will become the world's biggest economy. Should America care?

Being the biggest economy has its attractions. It helps to provide military security and gives a country more clout in global economic affairs. Being the main reserve currency is also useful. America's ability to borrow and to settle its imports in dollars has saved it from paying more interest to finance its profligate ways.

However, remaining number one cannot be an end in itself. The goal of economic policy should be to improve living standards, which depend on a country's absolute, not relative, rate of growth. Indeed, an obsession with remaining number one could lead America to adopt policies that are likely to hasten the day China pulls ahead. Trade barriers, subsidies and restrictions on offshoring merely shield inefficient firms that need to become more productive if America is to thrive.

If rich economies raise import barriers in the misguided belief that they will protect Western living standards, they could destroy the main source of wealth-creation in the 21st century. They could also deny better living standards to hundreds of millions of people in the developing world. It is rich countries' fear of emerging economies' success, not that success itself, that is the real danger to the world economy. It would be ironic if the triumph of free trade and market economics in the emerging economies were to turn the rich world more protectionist and interventionist. If they continued down that path, today's rich countries might even end up as tomorrow's (relatively) poor ones.

That might sound far-fetched, yet China, once the world's technological leader, provides a sobering lesson on how economies can slide down the international league table. In the 18th century it was the world's biggest economy, with a GDP seven times as large as Britain's. But it kept its doors closed to foreign goods, so it was left behind by the industrial revolution and the explosion in global trade.

In 1793 Lord George Macartney was sent to Peking by King George III to establish a permanent British presence and open up trade relations with China. But the Chinese emperor Qianlong informed his visitor that “we have not the slightest need of your country's manufactures.” China's economic isolation was to last for almost another 200 years, during which real incomes fell. By 1950 China's GDP per person had shrunk by a quarter compared with Lord Macartney's day; Britain's had risen fivefold.

In America today the drumbeat of protectionism is getting louder. As this survey has argued, that is because although globalisation benefits economies as a whole, the gains are unevenly distributed, and the costs—job losses and lower wages—are much more visible than the wider benefits to consumers

generally. Workers tend to be better organised and more vocal than consumers.

In recent years, as profits have surged, most workers' real incomes have been flat or even falling; only those near the top of the tree have enjoyed big pay rises. Globalisation has shifted the balance of power against workers and in favour of companies. But unless ordinary folk are seen to share in the gains from globalisation, there will be growing demands for import barriers or much higher taxes on booming company profits.

The trouble is that, in a globalised economy, policies aimed at fleecing companies will fail to spread the rewards more widely. Firms will simply move to a more congenial environment. The best way to boost national economic prosperity is to make labour and product markets work more efficiently, speed up the shift of jobs from old industries to better-paying new ones, and improve education and training to prepare workers for tomorrow's jobs.

But that may not be enough. Governments may need to tackle sluggish wage growth and increased inequality more directly. Rich economies as a whole gain from the new wealth of emerging ones, so governments have ample scope to compensate the losers, but they rarely do. Yet there may be a case for helping out those who lose their jobs or have to manage on lower pay in order to ensure continued political support for free trade. The challenge for governments is to find ways to share out the fruits of globalisation more fairly without undermining the economy's ability to reap the benefits.

Shifts in economic power tend to be associated with disruptions in the world economy, and are rarely smooth. The globalisation that followed the industrial revolution was brought to an end by two world wars, high protectionist barriers and the Great Depression. Now the rise in emerging economies is once again altering power relations among states and creating new geopolitical risks. This new revolution, too, is bound to bring forth its share of disagreements.

How should the world's policymakers respond to the developing world's growing economic power? Big emerging economies will need to be given a larger stake in the smooth running of the world economy. As the world's fourth-biggest economy in dollar terms (and second-biggest at PPP), China should be a full member of all international economic policy forums, such as the G7 and the OECD. Yet these organisations remain firmly in the hands of the old rich economies. How can governments sensibly talk about pressing issues such as global imbalances or energy prices without China being present? The G7 should be pruned to a G4, consisting of America, Japan, the euro area and China; and the status of the G20, which already includes emerging as well as advanced countries, should be elevated.

IMF members meeting in Singapore this month are expected to agree to give more votes on the organisation's board to some of the bigger emerging economies, in recognition of their growing weight in the world. Several developing countries, especially in Asia, are hugely underrepresented, whereas rich European economies are overrepresented. China currently has only 3% of the total vote, not much more than Belgium (with 2.2%), even though China's economy is seven times larger at market exchange rates and a lot bigger still at purchasing-power parity.

America v Europe

Which developed economies will gain most from the emerging economies' new economic muscle? Conventional wisdom has it that America's economy is coping much better than Europe's with competition from emerging economies, thanks to its flexible labour and product markets. According to this view of the world, Europe is having a tough time dealing with globalisation, burdened by high minimum wages, extensive job protection, high taxes and generous welfare benefits. Many people blame the euro area's sluggish growth in output and jobs in recent years on its loss of global competitiveness.

But conventional wisdom may have got it wrong. Since 1997 employment in the euro area has grown slightly faster than in America. Over the past decade, European firms have been much more successful than America in holding down unit labour costs and thus remaining competitive. And since 2000 the euro area's share of world export markets has risen slightly, to 17%, whereas America's share has slumped from 14% to 10%. Thus, by many measures of competitiveness, Europe appears to be coping better with the emerging economies than America.

The main reason why America's economy has been growing faster than Europe's is that sluggish real wages have been offset by large capital gains on homes, massive borrowing and an unsustainable fall in saving, all of which have boosted American household spending. If (when) house prices fall and

consumers wake up to the fact that they are not saving enough, consumer spending will weaken perceptibly. Americans need to prepare for a recession or, at best, a prolonged period of below-trend growth.

In a few years' time, the relative economic fortunes of America and the euro area could be reversed. A report by IXIS, a French investment bank, suggests that Germany and Japan are much better placed to benefit from growth in emerging economies than America or Britain. Germany and Japan export 7-9% of their GDP to emerging economies; the equivalent figure for America and Britain is only around 3% (see chart 16). France and Italy are somewhere in-between. The euro area's exports to emerging economies have grown by an annual average of 14% since 2000, twice as fast as America's.

A report by Goldman Sachs also finds that by some measures Europe has benefited more than America from trading with the BRICs. The bank concludes that Germany and France are set to enjoy big gains. Italy, Greece and Portugal are less well placed because the make-up of their exports is closer to that of the BRICs, so they will face head-on competition.

For globalisation to benefit economies, resources must be reallocated towards higher-value-added goods and services. So to reap the full gains, Europe must urgently push ahead with making its markets more flexible and open. A study by the European Commission concludes that, if the European Union were fully to embrace the rise of China and India, its GDP per person by 2050 could be up to 8% higher than it would otherwise have been, implying a boost to average annual growth of 0.2% over the period. If, on the other hand, EU countries lurch towards more protectionist policies, GDP per head could be 5% lower than in the base case.

Japanese firms and workers have even less reason than American and European ones to fear China's economic might. Japan has been a major beneficiary of regional integration in Asia, and China is likely to overtake America as Japan's biggest trade partner by the end of this year. Japanese firms have invested heavily in China, shipping capital-intensive components there to be processed and assembled by cheap labour before being re-exported. Exports to China have played a big part in Japan's export growth in recent years, helping to spur its economic recovery. A survey by the *Nihon Keizai Shimbun* found that most big Japanese firms think a large appreciation of the yuan would not be in their interest because they have moved so much of their production to China.

Coming of age

The fact that people in rich countries are fretting about the emerging economies' success, rather than just their poverty, is itself a remarkable tribute to the progress those economies have made. Poverty in the third world is still rife, but rising incomes there should be welcomed by all. As long as they continue on their path of reform, there is an excellent chance that their rapid expansion can be sustained for several more decades.

China and India offer immense opportunities, but they also bring new risks. If these economies stumble, or even if they simply decide to sell their American Treasury bonds, the world will certainly notice. Because of the emerging economies' increased economic weight, a crisis there would have a much bigger impact on the global economy than formerly.

It is important to keep a sense of perspective. America still remains the world's biggest manufacturer, some way ahead of China. On visiting Beijing and Shanghai, many foreigners conclude that China is already a wealthy economy, yet China and India have more poor people than Africa does. Conversely, sceptics who try to downplay the importance of China and India underestimate the huge adjustments that lie ahead. China's vast labour force and its unusual openness to trade mean that its global impact is bound to increase. One day it will regain its place as the world's largest economy. And China is only one among scores of emerging economies that look set to prosper.

When your correspondent started as a journalist at *The Economist* in 1985, the world economy she was writing about consisted largely of the G7 economies. Twenty-one years later the emerging economies

have come of age. To understand the world economy, it is now necessary to understand and track the new world, especially Asia. That is why this correspondent is about to move herself and her economic toolkit from London to Hong Kong.

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Sep 14th 2006
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This survey has benefited from the help of many economists, not all of them mentioned in the text. The staff at the IMF, BIS, OECD and the World Bank were particularly generous with their time. Special thanks go to Eswar Prasad, Jean-Philippe Cotis, Bill White, Matthew Slaughter, Nouriel Roubini, Brad Setser, Bert Hoffman, Jiming Ha, Yu Yongding and Arthur Kroeber. A forthcoming book by the World Bank, "Dancing with Giants: China, India and the Global Economy", is highly recommended.

This survey has drawn on many sources. The following books and papers were particularly helpful:

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Sep 14th 2006
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Social networking

Hanging with the in-crowd

Sep 14th 2006
From The Economist print edition

Big media firms and investors are cosying up to social-networking websites

WEBSITES for social networking have never had so many friends. The best known, MySpace, recently became the most visited website in America. Its acquisition last year by News Corporation, a media giant headed by Rupert Murdoch, for $580m now looks like a masterstroke. Other media groups and investors are crowding around other such websites, which allow people to create their own pages with photos and blogs and make connections with other people. Takeover rumours have been swirling around two smaller sites, Facebook and Bebo. And a group of investors recently put $10m into Friendster, an early example of the genre that is trying to make a comeback. Even Wal-Mart, an American retailing giant, has started a social-networking site, called The Hub—to widespread derision, because it forbids the racy content that users enjoy.

After plenty of initial scepticism, investors now accept that MySpace and its rivals can make a lot of money by selling advertising space. Advertisers were wary of putting ads on individual home pages, which often feature lewd and unpredictable content. But they cannot ignore the fact that millions of young people spend hours on these websites. Last month MySpace made a deal allowing Google, an internet-search giant, to sell a big chunk of ad space on MySpace and on News Corp's other websites over the next three years. Google has guaranteed a minimum of $900m in revenue in return.

The more attractive social networking becomes as a business, of course, the more competition there will be. The very biggest internet firms—Google, Yahoo! and AOL—have all launched services, but so far independent ones have been the most popular: MySpace, the biggest, has over 108m users. So potential buyers are circling and MySpace's rivals are jockeying for position.

MySpace invaders

This week Facebook, with around 9m registered users, made a move to take on MySpace. Facebook was founded by Mark Zuckerberg, a student who put Harvard's yearbook on the internet in 2004. His creation then spread to Yale and beyond. It now covers most American colleges and many high schools. In

contrast to MySpace, which accepts everyone, Facebook is based on separate, closed networks for each college or school; members can link to someone in another network only with his permission. This allows Facebook to provide a more exclusive, secure and trusting environment than MySpace—and to earn more from advertisers, who want to sell to college students. Chris DeWolfe, the chief executive of MySpace, says Facebook has done a brilliant job at colleges, “but it's limited to that, and it will be easy [for rivals] to copy outside America.”

But on September 12th Facebook announced plans to fling open its doors and introduce regional networks for the whole world, open to everyone. “We want to be a universal utility,” says Mr Zuckerberg, who wants to move beyond Facebook's academic niche. Meddling with the formula could prove controversial: last week the firm provoked angry protests when it introduced, and then had to disable, a new feature that issued automatic alerts to users about their friends' activities on the site. The personal nature of the information posted on social-networking sites means users are sensitive to any changes—and wield unusual power as a result.

Other networks are not sitting still, either. MySpace is expanding overseas, though it has been overtaken in Britain by Bebo, a rival site popular with teenagers, according to Hitwise, a firm that tracks internet usage. Bebo trails behind MySpace and Facebook in America, but wants to be first or second in English-speaking countries, says Jim Scheinman, its head of business development. Cyworld, the biggest social-networking site in South Korea, recently moved into America and Taiwan and is already available in China and Japan. And Mixi, the dominant site in Japan, went public this week in a spectacular debut on the Tokyo Stock Exchange.

The newly revived Friendster is aiming at urban professionals in their 20s and 30s. Kent Lindstrom, its new president, says that whereas MySpace is “for people when they want to express their party, fun self, Friendster is more solid—it's where you keep your real friends for life.” But Friendster's greatest strength may be the patent on social-networking it was awarded this year in America. Mr Lindstrom says Friendster is considering its options, which could include sending out “cease and desist” orders to other social networks, or demanding that they pay licence fees. “Friendster probably has a greater opportunity to generate revenue from its patents than from building up its business,” says Kevin Werbach, an expert in technology law at the Wharton School of the University of Pennsylvania.

Catching up with MySpace will be difficult, because as well as being the largest social network, it is also the most advanced in offering traditional media content. From the beginning, Mr DeWolfe saw it as a new kind of internet portal centred around culture. To that end, MySpace is far more active offline than its rivals. It is running a series of concerts, for instance, in which bands such as The Killers and Primal Scream play to tiny audiences of MySpace users in small venues. (The site's emergence as the MTV of its generation helps to explain why Tom Freston was sacked last week as the boss of Viacom, the media giant that owns MTV. Having fallen behind in this new area, Viacom is said to have considered buying Bebo, but balked at the asking price.)

The question for MySpace, says Mr Werbach, is whether it can grow into a business on the scale of Yahoo!, eBay or Amazon. Pali Research, an independent research firm in New York, estimates that MySpace had revenues of $150m and made a loss of $50m in the year to June 2006, after making payments to its founders. Pali predicts $300m in revenues and profits of $200m in the year to June 2007, excluding revenue from its deal with Google. Like other social-networking sites, MySpace has not had to advertise itself, and its users provide most of its content, which should produce profit margins.

Investors used to worry that social networks were just a fad—though such concerns are fading, since MySpace and Facebook seem to be keeping their appeal. A new worry, however, is what could happen if there are cutbacks in advertising spending. Advertisers tend to get out of the newest, least-proven forms of media first, so social networking is vulnerable, says Geoffrey Sands, head of global media and entertainment at McKinsey, a consulting firm. He expects a shakeout among social-networking sites if advertising spending falters, though the strongest will survive.

One defence for social networks is to develop other revenue streams. Last week MySpace announced that it would launch a music-download service later this year. Mr Zuckerberg points to Facebook's self-service marketing business, which charges under $50 for “flyers” on the site—to advertise a local restaurant or a club night—as a kind of advertising that should be immune to trends among big corporate advertisers. As far as their business models go, social-networking sites are still in their teen years, with bags of potential.

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Corporate governance

Pretext in context

Sep 14th 2006 | NEW YORK
From The Economist print edition

What has gone wrong in Hewlett-Packard's boardroom?

TO LOSE one charismatic female corporate leader is a misfortune, to lose two is carelessness—or so Lady Bracknell might have concluded after studying the boardroom mess at Hewlett-Packard. The abrupt ending of Carly Fiorina's reign as the computer-maker's chief executive last year was sad but probably necessary, given her weaknesses—though she will dispute this in a book due out next month. Certainly, HP has thrived under her replacement, Mark Hurd. This week's news that Patricia Dunn will step down in January as chairman of HP's board in favour of Mr Hurd may not prove so inspired.

Perhaps Ms Dunn had to go, if only to satisfy the mob that reacted so furiously to revelations that an inquiry into leaks by a board member (now known to be George Keyworth, who resigned from the board this week) involved unethical and possibly illegal activities by private investigators hired by HP. The investigators used sub-contractors who engaged in “pretexting”: the use of false pretences to obtain personal information—in this case, the telephone records of board members and nine journalists.

Although the use of pretexting to obtain financial data is expressly forbidden by federal law, there is some debate about whether pretexting to gain telephone records is illegal. Wilson Sonsini, HP's law firm, initially saw no problem with how HP was conducting the inquiry (see article). But on September 12th Bill Lockyer, California's attorney general, said he had enough evidence to bring criminal charges against people at HP. A federal investigation is also under way. For her part, Ms Dunn denies approving the use of pretexting, or any advance knowledge of it. It seems unlikely that if there were any conclusive evidence to the contrary, Ms Dunn would have been able to remain chairman for another day, let alone until January, says Jill Fisch of Fordham Law School.

Ms Dunn's allies say she has been made a scapegoat by a board that backed her leak investigations, but then failed to stand behind her this week. They also question the central role played by Larry Sonsini in the two days of deliberations that ended with Ms Dunn losing her chair, though not—for now—her place on the board. The nature of the legal advice given by his firm is likely to be fiercely scrutinised in the inquiries and trials that lie ahead. Surely, if HP's board needed a lawyer this week, it should have found someone independent, says one critic.

Ms Dunn won many admirers among corporate-governance reformers for her efforts to improve HP's famously dysfunctional board. She encouraged more open, honest discussion, replacing some directors who favoured corporate America's traditional always-back-the-chief-executive clubbishness. Previously, dissent had been crushed, most visibly when Ms Fiorina set about merging HP with Compaq.

In trying to stop leaks, Ms Dunn was doing the right thing, says Nell Minow of the Corporate Library, an online database of corporate-governance information, even though the methods used by the private investigators were wrong. “This was an attempt to hold offenders accountable, instead of the usual wrist-slap of Silicon Valley cronyism,” says Jeffrey Sonnenfeld of the Yale School of Management.

Even in the best boards directors will occasionally disagree with their colleagues, or sometimes go public. One test of whether this would be right is whether it would be in the interest of shareholders. Tom Perkins, a legendary Silicon Valley venture-capitalist, arguably failed HP's shareholders by not making it public that his resignation in May was in protest at the nature of the leak inquiry, especially after HP did not do so in announcing his departure. Pat McGurn of Institutional Shareholder Services says that Mr Perkins had a duty to make a “noisy exit” by putting his reasons in writing to shareholders.

HP won praise from corporate-governance reformers for splitting the role of chairman and chief executive following Ms Fiorina's departure. According to a survey by Spencer Stuart, an executive recruiter, only

9% of the firms in the S&P 500 have a chairman who is genuinely independent of the chief executive; 70% of firms combine the roles, as HP now will. Separation can be helpful, especially in times of crisis and transformation. One step for Mr Hurd might be to find a heavyweight to replace him in his newest job.

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Corporate governance

The lawyer behind the throne

Sep 14th 2006
From The Economist print edition

HP's woes throw a spotlight on Silicon Valley's most powerful lawyer

FEW beyond California's technology crowd recognise the name Larry Sonsini; none within its circle could fail to. For four decades he has been lawyer, adviser and friend to many prominent companies and investors. Some consider him the most powerful person in Silicon Valley. Companies beg for his law firm to represent them. The 65-year-old chairman of Wilson Sonsini Goodrich & Rosati (WSG&R) has suddenly been thrust into the spotlight: first, for counselling many of the technology firms now under scrutiny for backdating stock options (and in some cases, serving on their boards); and more recently, as outside counsel to Hewlett-Packard (HP), for initially defending the board's dubious investigative practices.

WSG&R boasts 600 lawyers and represents around half of Silicon Valley's public companies, including Apple, Sun Microsystems and Google. Last year it ranked first in private-equity and venture-capital deals, with nearly twice as many as its closest rival. Over the past five years WSG&R has worked on over 1,000 mergers and acquisitions, collectively worth over $260 billion.

The recent troubles cast a shadow over WSG&R's reputation. Although Mr Sonsini is not accused of wrongdoing himself, many of his firm's clients are on the ropes. Former executives at Brocade Communications suffered criminal charges in July. Mr Sonsini served on Brocade's board until last year and his firm was its outside counsel. He also was on the boards of Pixar, Echelon, Lattice Semiconductor, LSI Logic and Novell—all firms at which the issuing of stock options is being called into question.

WSG&R dismisses the idea that Mr Sonsini faced a conflict of interest by acting as both director and legal adviser to so many firms and says he did not advise HP in its investigation of board members. Mr Sonsini initially said it was “well done and within legal limits”. It now seems it was neither.

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Movie downloads

Apples for couch potatoes

Sep 14th 2006 | SAN FRANCISCO
From The Economist print edition

Steve Jobs wants to move beyond music-on-the-go to films-on-the-sofa

Get article background

“YOUR den, your living room, your car and your pocket: I hope that gives you a little bit of an idea of where we're going,” said Steve Jobs, the boss of Apple Computer, at the end of his most recent product announcement, on September 12th. Apple's iPod music-players are probably already in your pocket and in your car (70% of new cars in America are now compatible with them). And Apple's laptop and desktop computers are in more dens than they used to be. So the living room had to be the next step in Mr Jobs' astonishing revival of the company that he co-founded, was fired from, rejoined and resuscitated over the decades. That means two things: selling films online, and somehow getting them into television sets.

Reuters

Not all pirate videos are bad

And that is what Mr Jobs announced. iTunes, Apple's online music and video store, now offers Hollywood films for download. And a new gadget, code-named “iTV” and due to go on sale early next year, will allow those films to be sent via a wireless link to television sets from the computers that run iTunes in the proverbial dens. Apple has thus staked its claim in two new areas. One is the promising market for video-on-demand, now worth $1.7 billion a year, but likely to grow to $12 billion by 2010, according to iSuppli, a research firm. The other is the fiercely contested “digital home” market.

In this area Apple's reputation for making things easy to use gives it an advantage. Moving digital content—photographs, music, videos—from computers to television sets is “the crux of it all”, says Kurt Scherf of Parks Associates, a consultancy. Technology giants such as Microsoft, Sony and Cisco sell products that do it, but are so fiddly that hardly anyone bothers. Apple's new box, if it works as billed, promises to be different: it has a tiny and simple remote control, with one button and one wheel.

Selling films online will be more of a struggle. Apple's announcement came a week after Amazon, a big online retailer, launched Amazon Unbox, its own film-download service, to mixed reviews. Other websites, such as Movielink and CinemaNow, have been offering similar services for years. And telecoms firms are investing huge sums to compete with cable companies, by offering video on demand through broadband connections.

So Apple is unlikely to dominate video downloads in the way that it dominates music downloads. Mr Jobs

persuaded the record labels (which were panicking about illegal internet downloads) to sell music on iTunes for 99 cents per song, and then used music as a loss leader to make money from his gadgets. The Hollywood studios “saw that and learned a lesson”, says Tom McInerney, the boss of Guba, a website that also sells film downloads. Most studios now want to prevent Apple from gaining the same power in video that it has in music, he says.

Mr Jobs has only one media company as a partner so far, and not a very surprising one. Earlier this year, Mr Jobs sold Pixar, an animated-film studio that he had co-founded, to Walt Disney, and joined Disney's board. So iTunes will sell films from Disney itself, and from Pixar, Touchstone and Miramax, its other studios. By contrast, Amazon, which Hollywood finds less threatening, has deals with all the main film studios except Disney's.

Other differences between films and music may also put a damper on Apple's ambitions. Compared with songs, feature films are huge digital files. Mr Jobs suggested that it would take about half an hour to download a movie into iTunes, but then admitted *sotto voce* that this assumed an internet connection much faster than is available to most Americans. Even then, iTunes will sell films at a resolution that does not do justice to the high-definition TV screens that are now becoming common in the sophisticated households Apple targets. For the time being, people may be happy to stick with services like Netflix, which lets them choose films online, and then sends a DVD in the post.

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About sponsorship

An Apple mobile phone?

I came, iPod, iPhone

Sep 14th 2006
From The Economist print edition

Why Apple is taking its time in launching a mobile phone

Get article background

EVERY Apple product-launch is preceded by feverish speculation about what, exactly, Steve Jobs will have up his sleeve. This week's unveiling of a movie-download service was correctly predicted by many of the websites devoted to Apple-related trivia. Oddly, however, the most talked-about product among Apple-watchers is one that the company has yet to admit even exists: an Apple mobile phone, or iPhone. It is an obvious product for Apple, given the power of its brand, and the threat to the iPod posed by mobile phones with built-in music players. So where is it?

The problem for Apple is that mobile phones are not like iPods, but are sold in a completely different way. People do not generally buy them in shops, but from mobile operators. And they do not pay the full price of the handset, but get a subsidy from the operator in return for signing a service contract. So if Apple sells iPhones as though they were iPods, they will be far more expensive than competing handsets. The alternative is for Apple to sell iPhones through operators, as other handset-makers do. But being reliant on operators, with their poor reputation for customer service, could damage Apple's iconic brand.

A third option would be for Apple to deepen its partnership with Motorola, the second-largest handset-maker. The two firms have already worked together to add Apple's iTunes software to some of Motorola's phones. But it seems unlikely that Mr Jobs, a legendary perfectionist, would want to co-brand a handset with Motorola. And any such phone would still have to be sold via operators, as Motorola's are today.

There is another option: for Apple to set up as a mobile operator itself, by leasing network capacity from an existing operator. This is known in the industry as a “mobile virtual network operator”, or MVNO. It would give Apple complete control over sales, service, support and billing. But it would be expensive and risky. The MVNO launched this year by ESPN, a sports channel owned by Disney, has been a flop. Yet perhaps Apple's powerful brand would see it through. For Apple's fans, it could be a case of iPhone, therefore I am.

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Russian energy

Hardball

Sep 14th 2006 | MOSCOW
From The Economist print edition

Would the Kremlin really renege on Russia's biggest foreign investments?

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TYPHOONS, earthquakes and a frozen sea make life difficult enough for the two consortia extracting oil and gas from beneath the Sea of Okhotsk, off the coast of Sakhalin Island in the Russian far east. Political irritants, however, are proving to be just as troublesome.

The two mega-projects, led by Exxon Mobil and Royal Dutch Shell, are the biggest foreign-direct investments in Russia. Sakhalin Energy, the Shell-led enterprise, began pumping oil in 1999; oil and gas will eventually be sent through twin pipelines to an oil terminal and a liquefied natural-gas (LNG) plant at the island's southern tip. Meanwhile, Exxon and its partners have just sent their first oil across the Tatar Strait.

Exxon and the Russian government are bickering over the rights to deposits around the edge of the consortium's fields. Sakhalin Energy, meanwhile, has been bedevilled by environmental problems. An offshore pipeline had to be rerouted to avoid the feeding ground of an endangered whale and the onshore pipes cross more than 1,000 rivers and streams as they sweep down the skinny island. That has alarmed environmentalists—and jeopardised a loan from the European Bank for Reconstruction and Development. The government also claims to be worried: last week an environmental regulator said it would ask the courts to stop the project.

But, as one Russian minister hinted, the government's motives may not be entirely green. Last summer Sakhalin Energy said its costs had almost doubled, to $20 billion. Under a “production-sharing agreement” (PSA), the state takes a share of the profits—but mostly only after the costs have been recouped. So the Kremlin is peeved.

Indeed, some Russian officials have now soured on the whole idea of PSAs, which also apply to Exxon's Sakhalin project and to a Siberian development led by Total, a French firm. Signed in the mid-1990s,

when oil prices were low and Russia was struggling, the PSAs were designed to insulate big investors from legal and taxation changes, but are now seen as anachronistic relics of a humiliating era. Officials, including a presidential aide, mutter about revising or scrapping them.

It is hard to know how far such comments reflect official policy. They could simply be a way to put pressure on the foreign firms to do something about the cost overrun, or to encourage them to bring in Gazprom, Russia's state-controlled gas giant. Sakhalin Energy has the dubious distinction of being the only big energy project in Russia not to involve a Russian firm, and the two big Sakhalin projects are the only exceptions to Gazprom's gas-export monopoly. Gazprom wanted to be involved: last year it agreed with Shell to swap a share in Sakhalin Energy for a stake in a Siberian field. Then the cost overrun was announced, and Gazprom squealed.

Sergei Kuprianov, Gazprom's spokesman, rebuffs the idea that the company and the government are in cahoots. Gazprom won't mind all that much, he says, if the Sakhalin deal falls through. But the government's environmental worries, and anger over Sakhalin Energy's costs, seem to have something to do with Gazprom's bargaining. The Kremlin would probably never be rash enough to assail the PSAs: it is much easier just to secure favourable participation for state firms. Probably.

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Pharmaceuticals

Dispensed with

Sep 14th 2006 | NEW YORK
From The Economist print edition

Yet another boss of a big drugs company loses his job

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NOW is not a good time, it seems, to be running a big pharmaceuticals firm. In the past year and a half the bosses of three such giants have been fired, two of them in the past two months. The three sackings, admittedly, had quite different causes. Merck booted out Raymond Gilmartin in May 2005 in the wake of the Vioxx scandal, in which the firm had to recall its blockbuster arthritis drug when it was linked to an increased risk of heart attack. Henry McKinnell's departure from Pfizer this July was the result of his arrogant and aloof response to shareholders' concern over the firm's sinking share price. And the removal of Peter Dolan from the top job at Bristol-Myers Squibb (BMS) this week came as a result of his mishandling of a challenge posed to Plavix, the company's lucrative blood-thinning drug, by a generic rival. But the three cases are all, in some ways, the result of deeper trends.

Viren Mehta, an industry analyst, argues that two recent shifts have conspired to put drugs bosses in a difficult position. The first, he argues, is that the pharmaceutical industry is “in the midst of a journey from ‘old science’ to ‘new science’.” The industry's traditional model, based chiefly on chemistry and basic biology, is giving way to a new approach based on biotechnology, computing, advanced chemistry and combinations of the three.

As drugs bosses invest huge sums to help their firms master these new skills, however, the second shift makes it harder to do so. They are finding that the once-reliable sources of profit from traditional drugs are suddenly drying up. An unprecedented number of patents will expire this year and next and new drugs have been slow to emerge from research pipelines. More troublingly, generics firms are now even challenging patents—such as the ones held by BMS for Plavix—that were expected to deliver profits for years to come.

The new reality of the pharmaceuticals business, says Mr Mehta, is that the market for a blockbuster drug can collapse almost overnight. He is not exaggerating: in August BMS lost 75% of the market for Plavix in just a couple of weeks to its generic rival. In this difficult environment, missteps that might have been tolerated in rosier times can put a boss's head on the block.

The much harsher financial outlook for big pharmaceutical firms is the link between the three sackings, says Chris Schott of Bank of America, an investment bank. Revenue growth of 10-15% may have been possible in the past, but today many drugs giants face stagnant growth or worse. As the prospects for growth have diminished, so too have drugs companies' share prices. But, says Mr Schott, some bosses are still stuck in “an aggressive-growth mentality” and make strategic errors as a result.

So can replacing the chief executive really fix what ails these companies? It is too early too tell. Richard Clark gets generally good marks for steering Merck through the Vioxx affair, but he struck a sour note last week with the release of a company-funded “outside” investigation into the matter that critics said was a whitewash. Jeffrey Kindler, the new boss of Pfizer, has made an impressive start, announcing a sweeping revamp and vowing to make his firm “more agile and entrepreneurial”—but whether he can really do so remains to be seen.

As for BMS, the future remains even more uncertain. Proclaiming that someone had to be “held accountable” for the bungling at the top, James Robinson, the firm's chairman, chucked out both the chief executive and the general counsel this week. The selection of James Cornelius as interim chief executive fuelled speculation that the board is ready to sell the firm. That is because when he held the same post at Guidant, a manufacturer of medical devices, Mr Cornelius lined up the firm's sale to Boston

Scientific, a rival device-maker. Perhaps the only safe job at the top of the pharmaceuticals industry today is that of interim chief executive.

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The art market

A pretty picture

Sep 14th 2006 | NEW DELHI
From The Economist print edition

Why Indian modern art is booming

IT IS not just Indian software and "business-process outsourcing" firms that are benefiting from the rise of the internet. Indian modern art is also on an upward spiral, driven by the aspirations of newly rich Indians, especially those living abroad, who use the internet to spot paintings and track prices at hundreds of gallery and auction websites. Prices have risen around 20-fold since 2000, particularly for prized names such as Tyeb Mehta and F.N. Souza.

There would have been "no chance" of that happening so fast without the internet, says Arun Vadehra, who runs a gallery in Delhi and is an adviser to Christie's, an international auction house. He expects worldwide sales of Indian art, worth $200m last year, to double in 2006. It is still a tiny fraction of the $30 billion global art market, but is sizeable for an emerging market.

For newly rich—often very rich—non-resident Indians, expensive art is a badge of success in a foreign land. "Who you are, and what you have, are on your walls," says Lavesh Jagasia, an art dealer in Mumbai. Indian art may also beat other forms of investment. A painting by Mr Mehta that fetched $1.58m last September would have gone for little more than $100,000 just four years ago. And a $22m art-investment fund launched in July by Osian's, a big Indian auction house, has grown by 4.1% in its first two months.

Scant attention was paid to modern Indian art until the end of the 1990s. Then wealthy Indians, particularly those living abroad, began to take an interest. Dinesh Vazirani, who runs Saffronart, a leading Indian auction site, says 60% of his sales go to buyers overseas.

The focus now is on six auctions this month. Two took place in India last week; work by younger artists such as Surendran Nair and Shibu Natesan beat estimates by more than 70%. Sotheby's and Christie's have auctions in New York next week, each with a Tyeb Mehta that is expected to fetch more than $1m. The real question is the fate of other works, including some by Mr Souza with estimates of up to $600,000. If they do well, it will demonstrate that there is strong demand and will pull up prices across the board. This looks like a market with a long way to run.

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Face value

Ecco il conto, presidente

Sep 14th 2006
From The Economist print edition

Marco Tronchetti Provera took control of Telecom Italia five years ago. Now the bill is due

Reuters

THREE weeks of sailing in the Mediterranean, even during a poor summer, does wonders for a tan. And Marco Tronchetti Provera's well-bronzed face bears the evidence of time spent at the helm of his 30-metre yacht, working up its 16-man crew and competing in regattas. “I have the physique but less time than I would like. Alas, in the future, when I may have more time, I may not have the physique,” he says.

His favourite pursuit was badly disrupted five summers ago when, in July 2001, as chairman of Pirelli, a tyre company he continues to head, Mr Tronchetti Provera did a deal to win control of Telecom Italia, Italy's former telecoms monopoly, and take over its chairmanship. To do so, he used Pirelli's cash pile of €4.4 billion ($3.9 billion), raised from the sale in 2000 of its fibre-optics business to Corning and Cisco Systems, two American firms. He also borrowed heavily—around €3 billion of loans were renegotiated last year—and took two banks as shareholders in Olimpia, the holding company used to buy the stake in Telecom Italia. But they imposed the condition that Pirelli would have to buy their shares back for at least the original purchase price. The banks renewed this arrangement after three years for a further two, and the bill is now due. Although Telecom Italia's shares are now worth €2.29, they cost €4.17 when Olimpia bought its stake, so Pirelli must pay out almost €1.2 billion next month. In July it paid almost €500m to buy back the shares of a company called Hopa that had bought into Olimpia in 2003.

To meet these commitments Mr Tronchetti Provera has had to dismember his business empire. Pirelli sold its cables division for €1.3 billion in June last year to concentrate on property and tyres. In June it sold a large stake in Internazionale, a leading Milanese soccer team of which Mr Tronchetti Provera is an enthusiastic fan, and in July it sold 39% of its tyre division to a group of banks to raise €740m. It has other assets on the block. Since shortly before Pirelli made its investment in Telecom Italia, the price of Pirelli's shares has fallen from €3.10 to €0.74.

This is the background to the dramatic U-turn that Mr Tronchetti Provera announced this week at Telecom Italia, which is based across the street from Pirelli's headquarters in Milan. Although he has sold assets, raising €15.4 billion since 2001 to pay down debt, Telecom Italia still has debts of €41.3 billion, almost equal to its stockmarket value. On September 11th Mr Tronchetti Provera announced that the company would split its mobile-phone division, Telecom Italia Mobile (TIM), and its fixed-line network,

into two new holding companies. This would, he insisted, enable Telecom Italia to focus on its broadband internet business and, in particular, the delivery of television services over broadband connections—a new market into which Telecom Italia is advancing, along with other incumbent telecoms operators around the world.

On September 7th Mr Tronchetti Provera met Rupert Murdoch, the boss of News Corporation, to discuss a partnership. “Thanks to broadband, telecoms and the media are converging and that is where we are moving,” says Mr Tronchetti Provera. The result, so far, is a small deal to supply films from News Corp's Twentieth Century Fox over Telecom Italia's wires. But rumours abound that some form of closer tie-up—such as a merger between Telecom Italia and Sky Italia, News Corp's satellite-TV unit—might also be on the cards. Either way, Mr Tronchetti Provera hopes that positioning Telecom Italia as a media company rather than a telecoms firm will boost its share price, since media firms tend to trade at higher multiples of their earnings.

If that fails, separating Telecom Italia's fixed and mobile networks into separate divisions provides a fallback plan. It is not necessarily the prelude to a sale, Mr Tronchetti Provera insists, though he has not ruled out that possibility, and it would make a sale much easier. He seems, in particular, to be inviting bids for TIM, which might fetch around €35 billion ($44.5 billion). Telecom Italia would reduce its debt, and Pirelli's proceeds from the sale would cover buying the two banks out of Olimpia.

But the sale of TIM, Italy's largest mobile operator, would be problematic. Mr Tronchetti Provera has long been one of Europe's leading proponents of “convergence”—the idea that telecoms firms should tightly integrate their fixed, mobile and broadband operations. Selling TIM, which was fully integrated into Telecom Italia only last year, would mark a complete reversal of this policy. The price would stretch both private-equity buyers and debt-laden rival operators. Worst of all, government ministers have condemned the plan, and one even called for a change of management. The unions threatened to strike.

Expensive hobbies

Mr Tronchetti Provera won accolades for the smart way he steered Pirelli during the 1990s. But his handling of the tyre group over the past five years would have provoked a mutiny by shareholders in most listed companies. Yet he is still in command. That is due partly to the chain of nested stakes that grants his family voting rights of 25.4%, despite holding less than 8% of Pirelli's shares. Friendships and alliances of cross-shareholdings, which often trump economic factors in Italy, have also helped him to keep his job.

Taking control of Telecom Italia proved to be a bad call. Mischievous Milanese insiders say that Mr Tronchetti Provera, whose family in effect owns less than 1% of Telecom Italia, wanted to head the telecoms giant because it offered more power and prestige than running Pirelli. He insists, however, that it was his duty as an industrialist to invest the gains from the sales to Corning and Cisco in an industrial venture, though he says he would have bought a bank had he guessed where Telecom Italia's shares were heading. “The value has halved,” he says. “I know because I have lost most.”

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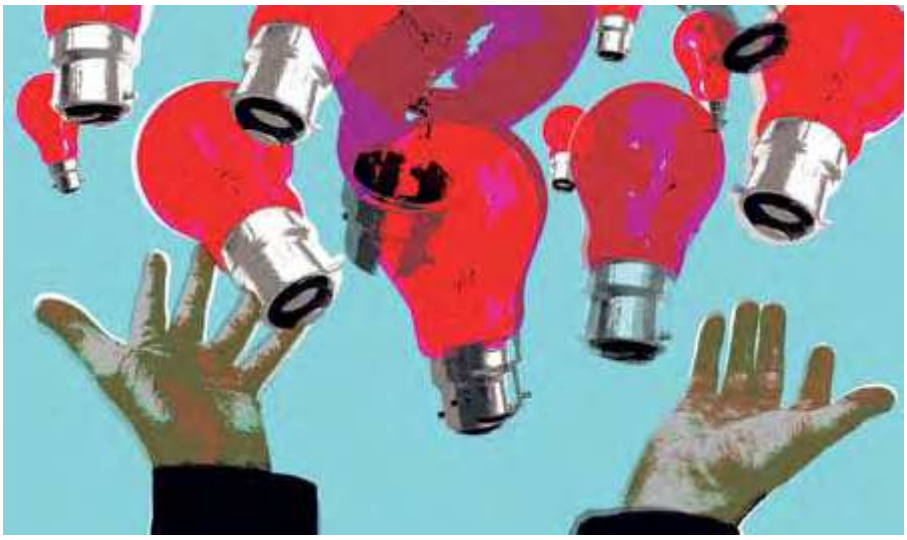
Business angels

Giving ideas wings

Sep 14th 2006
From The Economist print edition

Entrepreneurs can struggle to raise the first million or so, even with a good idea. But a business angel might smile on them



IN AUGUST 2003 Skype released the first version of its software, which allows people to make free voice and video calls over the internet. The company had raised its seed capital only a year before from a group of private investors, who had later been joined by venture-capital funds. It was a remarkable investment. In September 2005 Skype was bought by eBay for €2.1billion ($2.6 billion). The deal made its Scandinavian founders, Niklas Zennstrom and Janus Friis, millionaires many times over. For their part, the earliest investors saw a huge return, 350 times or so, on their estimated €2m investment.

Few start-ups can hope to become so big so fast. Most new companies wither and die in their first few years, leaving their investors out of pocket. That risk and would-be investors' unavoidable lack of knowledge when faced with unproven business plans explain why entrepreneurs struggle to finance their dreams. Not only must entrepreneurs find the money to get a business off the ground, but they will also need further finance if it is to flourish.

The search was never easy. But it has become harder in recent years with the opening of what has been called the “equity gap”—a scarcity of ready sources of outside financing for the smallest companies. This matters in an age that has recognised the part new businesses play in invigorating economies. Governments everywhere are desperate to help entrepreneurs start the companies that will create new jobs and new wealth.

Which is where the ragtag army of “business angels” comes in. Professional venture capitalists get all the kudos—and most of the money—but the informal choir of business angels plays a large role in starting the innovation machine rolling. Between them, the angels form an unofficial and little-known capital market on which the future is built.

The equity gap exists because two well-trawled sources of finance no longer overlap. In their earliest stages, start-up companies typically rely on precarious financing, such as their owners' credit cards, second mortgages or cash from close contacts. There is a limit to these sources, which professional venture capitalists disparagingly called the “three Fs”—family, friends and fools. They might provide the first $250,000 or so. But that is too meagre to bring to market the sort of groundbreaking ideas, like

Skype, that can eventually turn into a billion-dollar business. So another source of funds is needed.

Once, businesses would have turned to venture capitalists, who put up money in return for a stake in the enterprise. A decade or more ago $1m could have been raised this way. But as venture-capital funds have developed and expanded, so their ambitions have grown with them. Many are no longer interested in deals unless they are worth much more.

Most venture-capital firms in America will now consider only deals in which they can invest at least $7m, says Jeffrey Sohl, director of the Centre for Venture Research at the University of New Hampshire. Europe is not much different. British entrepreneurs struggle to find well organised investors if they are looking for less than £2m-3m ($3.7m-5.6m), estimates Colin Mason, academic director of the Hunter Centre for Entrepreneurship at the University of Strathclyde in Glasgow.

A wing and a prayer

Where can business people go to bridge this equity gap? British entrepreneurs could try a television programme such as the BBC's “Dragons' Den”. Contestants pitch their business plans to a group of potential investors to win the prize of some backing. But television is about entertainment. So, one of the show's advisers recently confided, “I find them a few mad people and plonkers.”

To avoid humiliation, it might be better to seek help privately, from some business angels. Angels are rich. They usually have business experience and are often prepared to invest in a risky venture. But they do not operate by the standard rules typical of stock exchanges or formal investment firms.

For all its obscurity, the market they operate in is huge. Mr Sohl estimates there are up to 350,000 business angels in America who invest around $30 billion a year in some 50,000 ventures, an average of $600,000 per investment. In contrast, venture-capital funds in America invest on average $6m in each venture, according to PricewaterhouseCoopers.

Business angels have a long history. America's National Venture Capital Association believes that over the past 30 years they have put more than twice as much money into new ventures as have venture-capital funds. In Europe business angels may be investing between €10 billion and €20 billion each year, thinks Mr Mason. He estimates there are as many as 40,000 business angels in Britain alone.

The angels' distant origins are on display in Mel Brooks's comedy “The Producers”. In the 1920s Broadway executives sought people like the little old ladies in the film to back their shaky new stage productions. In return, these backers—and here imagine a greenroom thick with endearments like “darling” and “angel”—could expect to rub shoulders with the stars at post-production parties. Rarely would they get their money back.

Where VCs fear to tread

Just as theatrical angels are now less star-struck, so business angels tend to be highly professional. Many are successful entrepreneurs in their own right. Others are well-paid managers or professionals who have specialist knowledge of an industry. Like most rich people, they prize anonymity and do not broadcast their activities, which can make them as hard to dig out as the details of their successes.

And they do expect success. Typically, a business angel is willing to invest between $25,000 and $250,000 in each of between five and ten new ventures. They expect to make money from the spread of investments, but Mr Sohl believes they also seek “psychic income”. Angels want the satisfaction of putting their commercial acumen, contacts and practical knowledge to work on behalf of talented people whom they like.

Such sentiment may explain why professional venture capitalists can often be critical of business angels. “Angels usually overvalue businesses. This makes it difficult for us to come in later on,” says one. Another adds: “Angels interfere in businesses, particularly in Britain where they have less experience.”

Mr Sohl agrees that there can be problems, cautioning would-be entrepreneurs to make careful inquiries into any prospective investors. “Finding out about your investors before you sign them up is critical,” he says. “And you have to understand what everybody wants from the business. It's a marriage without the

possibility of divorce. If you can't make it work, bankruptcy is the only alternative."

Sentiment also helps explain the differences between angels and venture-capital firms. The managers of venture-capital funds take an almost-universal fee of "two and 20"; a 2% annual management fee and up to 20% of any profits made by their funds. Angel investors set their own terms.

Despite the potential for acrimony, business angels and venture capitalists have to work together. Angels are an important source of deals for the bigger funds. In America, according to one estimate, angels introduce about two-fifths of the new investment opportunities seen by venture-capital firms.

Raising money will never be easy for the kind of new business that exists only on paper. Skype was no exception. Some 20 venture-capital firms are said to have refused to finance it in its early days. Many of these were sceptical about its business plan. Not only was the company setting out to take on the trillion-dollar telecoms industry, but its founders also bore the taint of litigation. In 2001 Skype's founders had set up Kazaa, an online file-sharing service that enabled people to download music from each other's computers—to the great irritation of copyright holders.

Litigation is just one of the things the big venture-capital funds now have to worry about. In the 1980s most funds were only worth $10m-20m. Today, most funds are worth more than $100m. The firms have to do a lot of work before investing. Because they owe fiduciary duties to their own investors, they must delve deeply into whether a new idea can work, the people behind it and whether there is a market for it. They must draw up contracts to allocate any profits and what will happen if anything goes wrong. These complex arrangements contain a baffling array of "liquidation preferences", "redemption rights", "anti-dilution protection" and other jargon. Few smaller investments justify all this paper work.

Another reason to avoid the smallest deals is that they promise lower overall profits than more mature ones do. According to the European Private Equity and Venture Capital Association, investments in "early stage" European ventures have in total made no money for their investors over the past 20 years, whereas later-stage ventures have provided 6% annual returns. Those totals, of course, contain a great many failures and a few big successes. Nevertheless, the record gives yet more reason for bigger funds to seek to avoid fledgling companies—especially those that have not yet put together a complete team of managers and so require extra attention.

Some entrepreneurs whose investment needs fall somewhere between venture-capital and angels can play one off against the other. But the market can be confusing. Venture-capital firms are often demanding, setting ambitious commercial objectives—milestones, as they are known—and complex provisions to protect the value of their shares. If things do not go according to plan, company founders can quickly end up losing their voting rights and even their jobs.

Besides offering entrepreneurs easier terms, angel investors have their own strengths and weaknesses. Sometimes, in fields where they have experience, they can advise managers on the nitty-gritty just as well as a venture-capital firm would. They may even have more time and patience to offer.

Their informality has its benefits, too. "The entrepreneur's life is a lonely one," Mr Mason observes. "His wife will leave, his employees will look for other jobs and his bank manager will repossess his house." Besides giving practical help, an experienced angel might also provide much-needed encouragement in the inevitable hard times. Angels can help young companies meet important new customers and recruit essential employees. And, says one business founder, business angels can help negotiate better terms with the venture capitalists when the day comes to scale up even further.

How should entrepreneurs find an angel? What was once a hit-and-miss affair is becoming increasingly systematic. Interest in investing in small businesses is growing among the wealthy, not least because of tax breaks that some countries offer. Business angels have started to organise themselves into groups that can go out and develop contacts who will steer promising opportunities in their direction.

These new networks gather angels into quasi-professional investment syndicates, allowing investors to spread their risk and take part in bigger and sometimes more attractive opportunities without betting the bank. Europe has perhaps as many as 200 networks already. Some contain a handful of investors; others have several hundred.

This more "professional" angel market is expected to bring with it specialisation and even brand recognition, thinks Mark Tluszcz, who is both an angel and a professional investor, as the managing partner of Mangrove Capital Partners, a Luxembourg-based venture-capital firm. Mr Tluszcz believes that

a small number of angels will eventually form a “first tier” in each industry, investing in a few specialist businesses. The most promising entrepreneurs will probably seek out these investors first. Any scheme they back will gain credibility at critical moments, such as when they are signing up the first big new customers or trying to lure a manager with valuable experience.

This rapidly evolving capital market even has its own award. The first winner of a European angel prize sponsored by three European business schools and a number of financial institutions was the German-born Klaus Hommels. A former manager at AOL, the “Entrepreneurial Private Investor” for 2006 has focused on how the internet can foster new markets, linking millions of consumers. Luckily for Mr Hommels, investing came early. He picked his first shares at 14, when his grandmother gave him $20,000 to invest. His portfolio has included several successes, notably Skype, and now he has interests in a handful of internet start-ups in China.

In addition to expecting his entrepreneurs to apply sensible commercial disciplines, such as knowing their market, Mr Hommels looks for obsession in the people he backs. “If you talk to them about vacations, they must always find a way to bring the conversation back to the business,” he says. One common European pitfall is that entrepreneurs too often think locally or nationally, but fail to grasp that there are much bigger opportunities afforded elsewhere.

Even a better-organised angel market—with or without awards—will still have its flaws. Mr Sohl, of the University of New Hampshire, believes that some weaknesses have already started to surface in America. He identifies a new, emerging “secondary equity gap”. Loose networks of angel investors are beginning to codify the terms on which they can work together, such as by agreeing investment strategies and standardising investment terms. That is sensible, because it makes it easier to do deals. The trouble is that such angel syndicates may start to behave more like venture-capital firms.

This risks having two unwelcome effects. One is that the syndicates will spurn smaller deals because of the cost of the paperwork. This would be at the expense of the market for seed capital, which means more businesses could struggle to get off the ground. Second, a more organised market could become more prone to the herd mentality that infected the venture-capital industry in the dotcom craze.

Wary since last year of a fresh outburst of exuberance, Mr Sohl now monitors the share of business plans in America that succeed in getting finance. In the long run, he estimates that only 10% of new ideas get enough money to set up. However, in 2000 the proportion shot up to 25%, before falling back to the teens during the bear market. He frets that since 2004 the approval rate has steadily risen from 18% to 23%. It is still rising. This rise may reflect the increasing supply of capital as existing angels lend more and new angels join the throng. Either way, some undeserving businesses are probably raising capital.

The value of nothing

It is all very well to talk in general terms about an overheating market. But in any single deal how do the entrepreneur and the angel work out whether the price is right? As any corporate financier will privately admit, assessing the value of even an established business is more art than science. When that business has rarely made a sale, let alone a profit, valuation becomes inspired guesswork.

David Beer runs a network that matches British entrepreneurs with prospective investors. In 20 years of observing start-ups, he has developed a simple rule of thumb. “If it's just an idea, it's worth £10,000; if it has a credible management team in place, it might be worth £100,000. On the other hand, if it has sold something for real money to real customers, it could be worth £500,000.”

Another investor says that early stage capital is flowing too freely now. He remarks that managers now “think 30 pages of business plan are worth $5m without a management team or even having made a

penny in sales." He believes that entrepreneurs have less humility than they once did. "You have to make these guys understand that they are better off with a smaller slice of a really big pie than owning most of a tiny business."

Although luck is a big part of finding the right opportunities, Anthony Clarke, president of the European Business Angel Network, offers further advice to budding angels. He advises avoiding lone wolves and backing fully formed founding management teams instead. The founders should show an innate ability to sell. And they must have a one-track mind and the obsession to work 60 or 70 hours week in, week out.

Perhaps of greater importance in raising finance is what angel networks now call "investor readiness". Few entrepreneurs realise that most angels will decide whether or not to look at a business in depth after skimming a business plan for only a couple of minutes. In spite of this, one commentator suggests that fully four-fifths of business plans put potential investors off, by being badly written or making implausible claims such as "we have no competition".

Ultimately, the success of any new venture will depend on the desire of people with ideas to risk their careers and livelihoods on the promise of wealth and success. According to the Global Entrepreneurship Monitor, an annual report of enterprise, the proof of such animal spirits depends on the fear of failure and the example of successful entrepreneurs. A survey on attitudes to entrepreneurship, sponsored by the European Commission, estimated that 26% of Americans would refrain from starting a business because of the risk to income and career. This share grows to 34% in Britain and to 46% in the European Union as a whole.

The European Business Angel Network says there is a social dimension to this disparate result. Americans are surrounded by entrepreneurs who have "cashed out" and have lived through a full cycle of founding, cultivating and then selling their businesses only to start all over again. Angels are more likely to put up their money if the person knocking on the gate has already worked out a heavenly exit route.

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Fund management

Alpha betting

Sep 14th 2006
From The Economist print edition

The industry is splitting in two—and investors are gambling on the expensive bit

IT HAS never been easier to pay less to invest. No fewer than 136 exchange-traded funds (ETFs) were launched in the first half of 2006, more than in the whole of 2005.

For those who believe in efficient markets, this represents a triumph. ETFs are quoted securities that track a particular index, for a fee that is normally just a fraction of a percentage point. They enable investors to assemble a low-cost portfolio covering a wide range of assets from international equities, through government and corporate bonds, to commodities. Morgan Stanley estimates that ETFs control some $487 billion of assets, up 16.7% from a year ago. It predicts they will have $2 trillion of assets by 2011. No longer must investors be at the mercy of error-prone and expensive fund managers.

But as fast as the assets of ETFs and index-tracking mutual funds are growing, another section of the industry seems to be flourishing even faster. Watson Wyatt, a firm of actuaries, estimates that "alternative asset investment" (ranging from hedge funds through private equity to property) grew by around 20% in 2005, to $1.26 trillion. Investors who take this route pay much higher fees in the hope of better performance. One of the fastest-growing assets, funds of hedge funds, charge some of the highest fees of all.

At first sight, this might seem like a typical market, with low-cost commodity producers at one end and high-charging specialists at the other. Buy a Rolls-Royce rather than a Trabant and you can expect a higher standard of luxury and engineering in return for the much greater price. But fund management is not like any other industry; paying more does not necessarily get you a better service.

An index represents the average performance of all investors, before costs are deducted. If the fee paid to the fund manager increases, the return achieved by the average investor must decline. After fees, hedge-fund returns this year have been feeble. From January 1st through to August 31st, the average hedge fund returned just 4.2%, according to Merrill Lynch, less than the S&P 500 index's 5.8% total return.

So why are people paying up? In part, because investors have learned to distinguish between the market

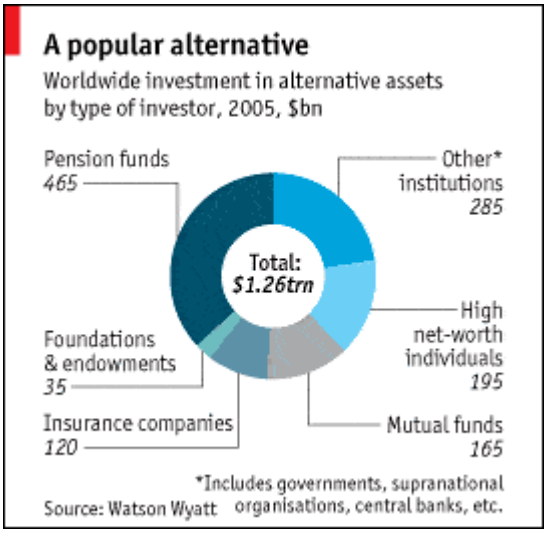
return, dubbed beta, and managers' outperformance, known as alpha. “Why wouldn't you buy beta and alpha separately?” asks Arno Kitts of Henderson Global Investors, a fund-management firm. “Beta is a commodity and alpha is about skill.”

The fund-management splits began with the decline of balanced managers, which took complete charge of an investor's portfolio, running everything from American equities through Japanese bonds to property. Clients became convinced that no one firm could produce good performance in every asset class, nor could they master the art of timing the switch from one asset to another.

Core and Satellite

That led to the “core and satellite” model, in which part of the portfolio was invested in index trackers with the rest in the hands of specialists. But this created its own problems. Relations with a single balanced manager are simple. It is much harder to research and monitor the performance of specialists. That encouraged the middlemen—managers of managers (in the traditional institutional business) and funds-of-funds (in the hedge-fund world).

They are usually even more expensive. Managers of managers, such as Patrick Disney of SEI (Europe), say they can use their buying power to keep fees down to the level charged by individual specialist managers. But even that tends to be higher than the charges of a traditional balanced manager, let alone an ETF.


A popular alternative
Worldwide investment in alternative assets by type of investor, 2005, $bn
Pension funds 465
Other* institutions 285
Total: $1.26trn
High net-worth individuals 195
Foundations & endowments 35
Insurance companies 120
Mutual funds 165
*Includes governments, supranational organisations, central banks, etc.
Source: Watson Wyatt

That such fees endure might suggest investors can identify outperforming fund managers in advance. However, studies suggest this is extremely hard (hence the rubric routinely attached to British financial products, “Past performance is no guarantee of future returns”). Nigel Williams of Barclays Global Investors, a big index tracker, says that consistently outperforming the market is hugely difficult.

And even where you can spot talent, much of the extra performance may be siphoned off into higher fees. “A disproportionate amount of the benefits of alpha go to the manager, not the client,” says Alan Brown at Schroders, an asset manager.

And yet investors may be willing to gamble, despite the higher fees, because they desperately need high returns. The bear market between 2000 and 2002 brought a sober reassessment of the future returns likely from equities and bonds. With bonds yielding 4-5% and equities returning perhaps 3% on top, composite future returns of 6% or so looked inadequate. Peter Harrison, chief executive of MPC, a fund manager, says that American pension funds have analysed their liabilities. “They need more than 6% to make up the shortfalls in their funds. Whether they earn alpha or not, they have to roll the dice and try to get it.”

The same rationale led to the enthusiasm for other forms of alternative assets, such as property and commodities. These appeared to offer a different source of returns that was not closely correlated to shares or bonds. The problem is that, as more money has piled in, the character of such assets have changed (see article). Prices have risen (reducing prospective returns) and exotic assets are more correlated with run-of-the-mill ones.

Diversification is supposed to be the one “free lunch” in the financial markets. However, these new market niches may be too small to absorb the amount of capital investors would like to place in them. Furthermore, top-performing managers, especially in hedge funds, may well close their doors to new investors to prevent returns being diluted. Even when you can identify the most skilful manager, it may be impossible to invest with him.

Nevertheless investors will probably keep pursuing alpha, even though the cheaper alternatives of ETFs and tracker funds are available. Craig Baker of Watson Wyatt, says that, although above-market returns may not be available to all, clients who can identify them have a “first mover” advantage. As long as that belief exists, managers can charge high fees.

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Reaction to Sarbanes-Oxley

Darned SOX

Sep 14th 2006 | LONDON AND NEW YORK
From The Economist print edition

In America and abroad, opposition mounts to regulatory overreach

EVERYONE knew exactly whom Britain's Treasury had in mind this week when it appeared to lay down the line on the creeping influence of financial regulators from abroad. Ed Balls, a senior Treasury official, said on September 13th that Britain's Financial Services Authority (FSA), the City's top watchdog, would be granted new powers to protect the country's "light touch" on regulation of exchanges. America was the bogeyman.

Although Britain worries about regulatory overreach tied to a possible bid by America's NASDAQ for the London Stock Exchange (LSE), it is not alone. America itself has seen plenty of grumbling. Acknowledging as much this week, Henry Paulson, America's freshly minted treasury secretary, backed a committee set up to review the Sarbanes-Oxley law and other aspects of capital-markets regulation.

American and foreign firms alike see Sarbanes-Oxley, which was passed in the wake of the Enron scandal, as intrusive, expensive and heavy-handed. Critics accuse it of causing foreign firms to list their shares in London rather than New York; others whinge about its onerous rules on internal controls used for financial reporting. There is an emerging consensus in America that the law needs to change. The New York Stock Exchange is lobbying hard, watching as the LSE's Alternative Investment Market makes the rounds in Silicon Valley, trawling for share listings.

There is now widespread expectation that Sarbanes-Oxley will be toned down next year (in light of this, Mr Balls' remarks look somewhat more opportunistic than confrontational). A full-scale repeal is unlikely, though, if only because of perceived improvements in corporate accounting and controls in America as a result of its passage. Lobbying from big accounting firms, that have been prime beneficiaries of Sarbanes-Oxley, is also likely to keep parts of the law in place.

From the British perspective, the long arm of American regulation has reached across the Atlantic with distressing frequency lately. Financiers point to the extension of a rule about hedge-fund registration (later struck down in an American court) to British funds, which are already regulated by the FSA. The financial press campaigned around the fate of the "NatWest Three", a group of British bankers extradited to Texas in July for the alleged abuse of the international banking system.

Seeking to bat down charges of protectionism in his remarks this week, Mr Balls said Britain did not object to foreign ownership of London's financial exchanges, just the imposition of foreign regulations. A London-based lawyer calls it "the Wimbledon argument—it doesn't matter who wins as long as they play here."

Yet some question whether Britain truly has the ability to fend off American regulation if there is an exchange merger. After all, global investment banks are already subject to the rules of both countries. This highlights the trouble with lines in the sand: sometimes the tide washes them away.

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Commodities

The slippery slope

Sep 14th 2006
From The Economist print edition

A fall in the price of oil highlights the traps in commodity investment

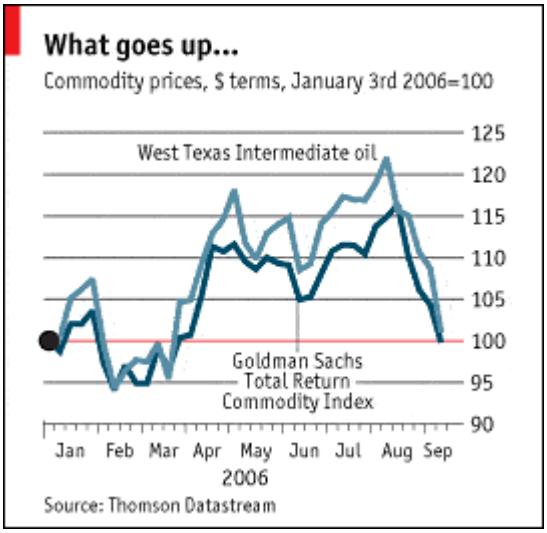
MEMBERS of the Organisation of the Petroleum Exporting Countries (OPEC) seemed in two minds when they met in Vienna on September 11th to consider changes to their production quotas. On the one hand, the oil price had fallen to its lowest level since March and later slipped below $64 a barrel. On the other, oil still costs more than it did when OPEC raised quotas to their present levels last year and twice what it did three years ago. In the end they resorted to a fudge: official quotas would not change, but members would be ready to cut output before they next meet if necessary.

OPEC's delegates are not the only ones in a muddle. Bankers' predictions of next year's oil price range from less than $50 to over $100. Some dismiss the recent slide in prices as just a seasonal blip in an otherwise enduring bull market, fuelled by growing demand from Asia and uncertain supply from places like Iran, Nigeria and Venezuela. Others see the beginning of the end of the cycle, as high prices stifle demand and the speculators who have piled into oil and other commodities in recent years take fright.

There is little doubt about the immediate triggers for the decline. America's appetite for oil often falls at this time of year, after the summer surge in petrol consumption has tapered off, but before winter prompts a rise in demand for heating oil. So far, the Atlantic hurricane season has not been as violent as forecast and America's row with Iran is also proving less tempestuous than many feared. Meanwhile, the International Energy Agency (IEA), an oil consumers' think-tank, has forecast lower demand growth, both for the rest of this year and for next.

Nonetheless, on the futures market, the price of oil for most of 2007 and 2008 remains near $70 a barrel. The IEA reckons that OPEC has no more than 2m barrels per day (b/d) of spare capacity—just over 2% of global demand. That is too small a cushion to compensate for a dramatic disruption in supply from Iran (which pumps 3.9m b/d), Nigeria (2.3m b/d) or Iraq (2.1m b/d), and barely enough to make up for another terrible hurricane in the Gulf of Mexico (1.5m b/d). In the next few years, several big new oil fields and refineries should come on stream. But until they do, the potential for sudden spikes in the price remains.

Another imponderable is the behaviour of the many investors with shares in funds that track the price of oil or other commodities. These funds' returns depend both on the overall movement of prices, and on the difference in price between contracts for prompt and future delivery. Since spot prices are usually higher than future ones, funds can normally buy futures contracts cheaply and wait for them to appreciate before trading them in for cheaper futures. At the moment, however, future contracts are dearer than current ones, so commodities funds are losing money each time they roll them over. The combination of negative “roll returns” and falling prices has meant many such funds have fallen behind the performance of oil for most of this year (see chart).



Moreover, one of the main reasons for investing in commodities, diversification, is weakening. In the past, prices for oil and gold, for example, tended to move in the opposite direction from shares, allowing investors to hedge against stockmarket slumps. But in recent months, points out Simon Hayley, of Capital Economics, a research firm, shares and commodities have begun moving in tandem. If investors' commitment to commodities

begins to waver, prices could tumble further, whatever the details of supply and demand.

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About sponsorship

The fight against corruption

Double-edged sword

Sep 14th 2006 | WASHINGTON
From The Economist print edition

The World Bank's anti-corruption effort has critics on the inside

AFP

Just the sort of busybody the bank likes

IN HIS airy office in Washington, DC, Paul Wolfowitz, president of the World Bank keeps a beautiful *keris*, a ceremonial dagger from Indonesia where he once served as ambassador. He recalls being impressed by the swordsmith, who could touch the red-hot metal from which it was forged with his bare fingertips.

Mr Wolfowitz currently has his hands full with something almost as hot to the touch: the issue of corruption—in the countries the bank supports and in the projects it finances. At its annual meetings next week in Singapore, the bank's political overseers will scrutinise its latest strategy for fighting graft. The president's fingertips may end up a little burned.

The new strategy was not his idea. But the bank's board insisted on it last spring after he had interrupted the flow of money to a number of countries and projects he found unsavoury. He asked awkward questions about a neo-natal health project in India (an earlier project had allowed harmful medicines to fall into the wrong hands); about forgiving the debts of the Republic of Congo even as its president ran up an $80,000 hotel bill in New York; and about lending money to Kenya once its anti-corruption czar, John Githongo, had fled the country after turning over one rock too many. Mr Wolfowitz saw these decisions merely as the application of common sense. But the board wanted to see the method in his meddling.

After numerous drafts of the 60-page strategy, that method is still not clear to all. The term “corruption” covers a multitude of sins, some petty, others grand. How are borrowers to know in advance which

blemishes will disqualify them for money? And who is to decide? After Mr Wolfowitz's scattershot approach so far, some of the bank's 24 executive directors, each appointed by member governments, want a bigger say in its future decisions.

The paper offers no shortage of principles to guide the bank's lending. But where those principles conflict, it is not clear which trumps which. For example, the bank believes that a free press, an army of busybodies (otherwise known as a thriving civil society) and an attentive parliament help to combat corruption. They raise the demand for honest government and provide a way to monitor it. Awkwardly, however, the bank's host for its annual meeting, Singapore, disproves this thesis. It is ranked the easiest place in the world to do business. But it is not nearly as friendly to the checks and balances of an open society. Earlier this month Singapore banned about 20 activists whom the bank had already approved for the meetings.

But in trying to stir the demand for reform in a borrowing country, the bank is constrained, at least in principle, by its articles of agreement, which prevent it from taking into account the “political character” of the regimes it deals with As *The Economist* went to press, Hilary Benn, Britain's minister for international development, was preparing to give a speech gently admonishing the bank for trying to do everything.

That is not all Mr Benn is unhappy about. He feels that the bank should not ask countries to pursue the economic policies it favours as a condition for getting its money. Britain had promised the bank an extra £50m ($94m) if it agreed to let countries make their own decisions. The bank is much less prescriptive than it was, but Mr Benn said this week he is not yet ready to hand over the extra millions. The bank will not miss the money (its soft-loan arm can lend about $11 billion a year). It will not miss the rebuke either.

But the approval of Mr Wolfowitz's overseers may be less important than the support of his underlings. The bank's staff *in situ*, in the poor countries it serves, traditionally pride themselves on moving money and maintaining the trust of the governments they help. The sharper, straighter edge Mr Wolfowitz wants to bring to the bank's operations will threaten both the cordiality of their relations and the size of their budgets. He says the bank's cadres on the ground feel “empowered” by his tougher stance. Maybe. But if he is wrong, the weapons outlined in the bank's new strategy will remain largely ceremonial.

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German financial regulation

The biter bit

Sep 14th 2006 | FRANKFURT
From The Economist print edition

Germany's financial watchdog fails to keep its own house in order

BANKS that step out of line can usually expect a strong dressing down from Jochen Sanio, head of BaFin, Germany's leading financial regulator. Mr Sanio, a picture-book Prussian with a neat moustache, loves a good scrap over legal matters in the banking industry.

So there has been a certain relish, not to mention *schadenfreude*, in seeing the pedagogue himself being brought to book over mounting evidence of sloppy administration at BaFin.

This week his position looked increasingly shaky. On September 26th Mr Sanio is due to give the board a full answer to findings, in a report by PricewaterhouseCoopers, that the Bonn-based financial authority was the scene of fraud, misallocation of funds and nepotism.

But Mr Sanio has no obvious successor. His grasp of complex regulation and his forthright views have served continental Europe well as it adapts, sometimes kicking and screaming, to Anglo-American capitalism. So finance-ministry officials are having to think carefully about when he should go—if at all.

Technically, Mr Sanio cannot be fired, but he could not operate without finance-ministry backing. BaFin is supervised by a board of ministry officials, politicians and practitioners. Prosecutors are investigating embezzlement of at least €4m ($5.1m) on information-technology purchases, as well as suggestions that at least five employees may have misused expense accounts and recruited some of their unqualified friends and relatives. If such goings on had been reported at a German bank, Mr Sanio would have been the first to wield the iron rod.

Will he get away with a warning? Peer Steinbrück, the finance minister, summoned him to Berlin for a dressing down on September 12th. Such a show of displeasure may have been calculated to relieve the media pressure. It is possible that Karl-Burkhard Caspari, the BaFin board member responsible for administration, would be a sufficient sacrifice to allow Mr Sanio to continue.

His critics—many of them German financiers who have felt his wrath—say he is dogmatic and that it is time for a change to a more flexible regime. On the other hand, Mr Sanio has valiantly fought the corner for continental Europe in the forging of new capital rules for banks, known as Basel 2, due to come into force next year. He has also worked hard on international-securities regulation and moves to stop money laundering.

Small wonder then if he neglected the administrative side at home. Mr Sanio's mistake was in not delegating someone to clean up the shop, especially after warnings from the federal audit office in 2004. What may hang him is evidence—if true—that he allowed a bad culture to take root.

If Mr Sanio survives, it is unlikely he will be able to strut the stage in Germany with the same sureness of tread (which has bordered on arrogance). His audiences may be spared those laborious metaphors, involving dancing masters and other Victorian anachronisms. But it will be hard to find Mr Sanio's match, from either within BaFin or outside, as the sparring partner and scourge of an industry undergoing rapid change.

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Indonesia's banks

Grip of the dead hand

Sep 14th 2006 | BANGKOK
From The Economist print edition

The state is slowly selling its banks, but still owns too many

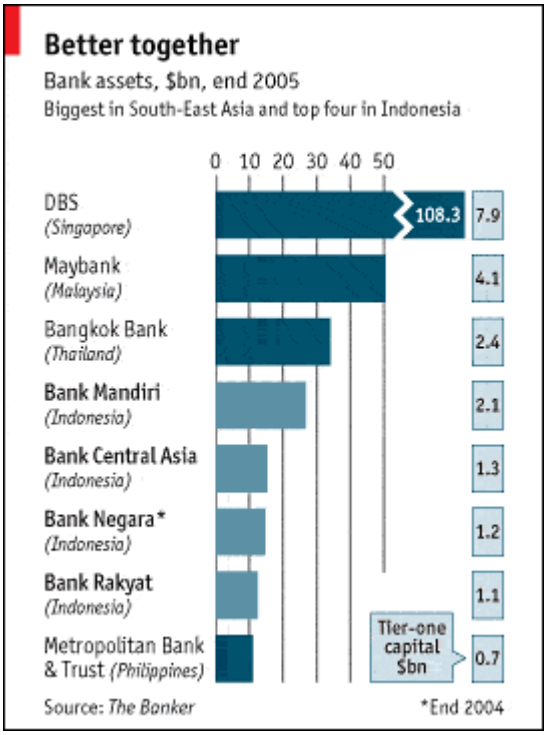
THE Indonesian government is taking an awfully long time to rid itself of the banks it rescued in the 1997 Asian financial collapse and to decide what to do with those it already owned. South-East Asia's biggest economy would be larger still if its banks had been freed sooner from the grasp of the state. Any progress has come in fits and starts. The latest twitch was on September 5th when the government sold its remaining 26% stake in Bank Permata, the country's eighth-largest by assets.

The buyers, paying 1.75 trillion rupiah ($193m)—a fairly generous 2.6 times book value—were Britain's Standard Chartered and its local partner, Astra. The pair had owned a controlling stake in Permata since 2004. The government's next sale may be its 5.5% remaining stake in Bank Internasional Indonesia, the sixth-largest lender. But that would still leave the state with control of three of the top four banks, plus holdings in a handful of smaller ones. The government is promising to produce, in the next few months, a medium-term plan. However, although its intentions are generally good, it has yet to show it can meet its own deadlines.

This is a pity because now might be “as good a time as any” to sell, reckons Ambreesh Srivastava of Fitch, a credit-rating agency. Despite occasional wobbles, the rupiah and the Jakarta stockmarket have risen sharply this year. Interest rates are falling. This is expected to enable Indonesia's banks to rebuild their profit margins.

Under previous governments, state banks were notoriously generous to political cronies and thus ended up with huge amounts of dud loans. There is much less of this under Indonesia's reform-minded but cautious President Susilo Bambang Yudhoyono. However, the banks are still stuck with a legacy of non-performing assets. At Mandiri, the largest (which is 69% state owned), a quarter of loans are non-performing. Even net of provisions, the ratio remains a worrying 14%.

Despite many closures since 1997, Indonesia still has 131 banks, which the central bank thinks is too many. It is especially keen on consolidating the larger ones. One idea is to foster two or three “international-scale” banks, each with capital of over 50 trillion rupiah, and a second tier of three to five “national” banks, each with capital of over 10 trillion rupiah. So far, Indonesia's big four banks are only middling regional contenders (see chart).



To encourage mergers, the central bank is phasing in more rigorous capital requirements by 2010. It will also ban anyone from owning a controlling stake (of over 25%) in more than one bank. This “single-presence rule” is mainly designed to force consolidation among banks in which foreign investors have bought stakes. The rule was supposed to come into force in 2008 but, earlier this month, the central bank gave in to pressure from bank shareholders and agreed to give them until 2010.

It appears that the government will itself be subject to the rule. If so, it will have to sell or merge some of the banks it controls. Selling would be better, but the government would have to defeat resistance to handing over national “crown jewels”,

especially to foreigners. Around half of the banking system is now foreign-controlled. Worse, among the keenest buyers have been the investment arms of the Singaporean and Malaysian governments.

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Economics focus

A seedbed of revolution

Sep 14th 2006
From The Economist print edition

Africa needs markets, as well as technology, for a green revolution to take root

NORMAN BORLAUG, who won the Nobel peace prize in 1970 for his role in the green revolution, remains as sturdy and "high-yielding" as the varieties of wheat he helped to invent. Last week, at the age of 92, he gave a stirring lecture in Washington, DC, calling for a renewed effort to bring his revolution to Africa, the one continent it bypassed first time around.

As if in answer to his plea, the Rockefeller Foundation, Mr Borlaug's former employer, and the Gates Foundation—run by Bill Gates, founder of Microsoft, and his wife Melinda—said this week they would devote $150m over five years to the cause. Some of this money ($63m) will be spent training more crop scientists and breeding new seed varieties suited to sub-Saharan Africa's parched climate, denuded soils and stubborn pests. But the two foundations, appreciating that technology is not the only obstacle, will spend almost as much ($61m) on the distribution of seeds as on their discovery. They will, for example, help village retailers and seed wholesalers set up in business, and push for financial reforms that would enable farmers and their suppliers to get credit.

The money is welcome, because crop science of the sort Mr Borlaug made famous has fallen out of fashion in recent decades. The International Rice Research Institute, for example, lost a quarter of its core funding between 2001 and 2003. These days biotechnology is mainly a profit-driven enterprise, creating seeds for big farms, often in rich countries. This skews its research, says Michael Lipton, of the University of Sussex. Herbicide-resistant crops, for example, allow weeds to be killed chemically, rather than plucked manually. This might reduce the demand for farm labour, which is scarce in rich countries, but in need of employment in poor ones.

But the sums announced this week, spread across as many as 20 countries, are not much in the scheme of things. The World Bank, for example, lent $537m to Africa for rural development in fiscal 2005 alone, without exciting much media interest. More importantly, the member governments of the African Union promised in Maputo in 2003 to devote at least a tenth of their budgets to agriculture by 2008, a scale of resources orders of magnitude greater than the Gates and Rockefeller millions.

This matters, because the green revolution's triumph in Asia owed as much to political commitment as it did to technical ingenuity. As Peter Timmer, a fellow at the Centre for Global Development, points out, Asian nations were too big to rely on food imports and too proud to depend indefinitely on the food aid America offered in return for loyalty in the cold war. New technologies were a necessary condition for the green revolution, but not a sufficient one. It succeeded because Asian governments made sure their farmers, big and small, were able and willing to avail themselves of fertiliser, irrigation and connections to markets. If Mr Borlaug was the father of the revolution, political necessity was its mother.

Why did Africa fail to emulate this success? Neither nature nor technology is the answer, according to a recent book on the subject*. Seed varieties suited to Africa's difficult conditions—where crops are watered by intermittent rains, not by a reliable system of irrigation—were invented. The first synthetic maize was released in Kenya in 1961 and even lowly cassava, a starchy root vegetable, benefited from genetic embellishments in the 1970s. But with some exceptions Africa's governments saw the new seeds and fertiliser as a way to secure political favour, not the food supply. In Nigeria credit and subsidies were hogged by "absentee farmers, retired civil servants and soldiers". Ethiopia's poor roads left the country's markets so fragmented that in 2001 smallholders in one part of the country were almost ruined by a glut, even as farmers elsewhere were ruined by drought.

Farmers in sub-Saharan Africa now use only about 9kg of fertiliser per hectare on average, compared

with 142kg in South-East Asia. Their reluctance has been put down to ignorance (farmers do not appreciate the benefits of fertiliser until they have tried it), timidity (they are wary of upfront commitments of money and prefer farming that delivers a reliable, even if low, return) or illiquidity (farmers cannot get the credit they need to afford seeds and fertiliser).

Food, glorious food

Few countries have ever enjoyed an industrial revolution without first undergoing a revolution in agriculture, a point both Mr Gates and Mr Timmer are keen to stress. Besides, raising yields on smallholder farms would have happy distributional consequences. Food is doubly important to the poor, because growing it accounts for a big share of their employment and buying it accounts for a big share of their expenditure. Raising farm productivity should, in principle, raise the incomes the rural poor earn from the food they sell, even as it reduces the price the urban poor must pay for the food they buy.

But cultivating a resilient, bountiful crop may be easier than cultivating an equally thriving market, with access to credit and distribution channels. The foundations understand this task, but no charity, however large, can accomplish it. African governments say they also understand it and have been as good as their word, recently agreeing to drop tariffs on the cross-border sale of fertiliser, a particular boon to landlocked countries.

For his part, Mr Borlaug is undeterred. For a nonagenarian, he puts great faith in youthful optimism. He wants to recruit “young people, right out of school” to his banner, reaching them before they have become accustomed to failure. In this business, the revolutionaries, as well as their seeds, must be resistant to the common blight of defeatism and despair.

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* ‘The African Food Crisis', edited by Göran Djurfeldt *et al*. CABI Publishing 2005.

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About sponsorship

Solar energy

Powering up

Sep 14th 2006
From The Economist print edition

Improved devices may make better use of sunlight

AP

MOST of the power generated by mankind originates from the sun. It was sunlight that nurtured the early life that became today's oil, gas and coal. It is the solar heating of the Earth's atmosphere and oceans that fuels wave power, wind farms and hydroelectric schemes. But using the sun's energy directly to generate power is rare. Solar cells account for less than 1% of the world's electricity production.

Recent technological improvements, however, may boost this figure. The root of the problem is that most commercial solar cells are made from silicon, and silicon is expensive. Cells can be made from other, cheaper materials, but these are not as efficient as those made from silicon.

The disparity is stark. Commercial silicon cells have efficiencies of 15% to 20%. In the laboratory, some have been made with an efficiency of 30%. The figure for non-traditional cells is far lower. A typical cell based on electrically conductive plastic has an efficiency of just 3% or 4%. What is needed is a way to boost the efficiency of cells made from cheap materials, and three new ways of doing so were unveiled this week in San Francisco, at the annual meeting of the American Chemical Society.

Solar cells work by the action of light on electrons. An electron held in a chemical bond in the cell absorbs a photon (a particle of light) and, thus energised, breaks free. Such electrons can move about and, if they all move in the same direction, create an electric current. But they will not all travel in the same direction without a little persuasion. With silicon, this is achieved using a secondary electrical field across the cell. Non-silicon cells usually have a built-in “electrochemical potential” that encourages the electrons to move away from areas where they are concentrated and towards places where they have more breathing space.

Cooking the chips

Kwanghee Lee of Pusan National University, in South Korea, and Alan Heeger of the University of California, Santa Barbara, work on solar cells made of electrically conductive plastics. (Indeed, Dr Heeger won a Nobel prize for discovering that some plastics can be made to conduct electricity.) They found that

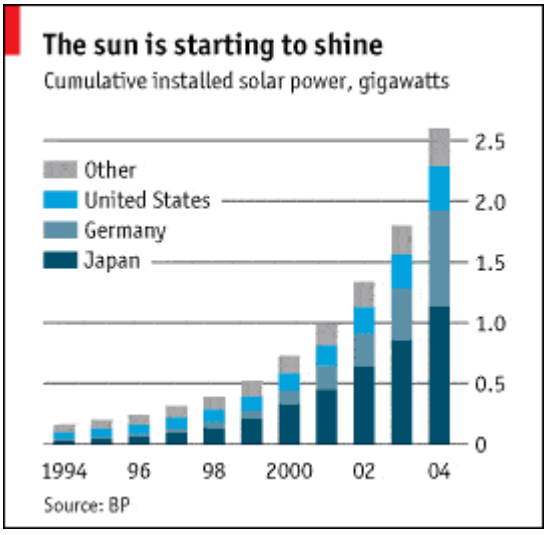
by adding titanium oxide to such a cell and then baking it in an oven, they could increase the efficiency with which it converted solar energy into electricity.

The trick is to put the titanium oxide in as a layer between the part of the cell where the electrons are liberated and the part where they are collected for dispatch into the wider world. This makes the electrically conductive plastic more sensitive to light at wavelengths where sunlight is more intense. Pop the resulting sandwich in the oven for a few minutes at 150°C and the plastic layer becomes crystalline. This improves the efficiency of the process, because the electrons find it easier to move through crystalline structures.

The technique used by Dr Lee and Dr Heeger boosts the efficiency of plastic cells to 5.6%. That is still poor compared with silicon, but it is a big improvement on what was previously possible. Dr Lee concedes that there is still a long way to go, but says that even an efficiency of 7% would bring plastic cells into competition with their silicon cousins, given how cheap they are to manufacture.

A second approach, taken by Michael Grätzel of the Swiss Federal Institute of Technology, is to copy nature. Plants absorb solar energy during photosynthesis. They use it to split water into hydrogen ions, electrons and oxygen. The electrons released by this reaction are taken up by carrier molecules and then passed along a chain of such molecules before being used to power the chemical reactions that ultimately make sugar.

Dye-sensitised solar cells seek to mimic this assembly line. The dye acts like chlorophyll, the pigment that makes plants green and that is responsible for absorbing sunlight and liberating electrons. The electrons are passed via a semiconductor to an electrode, through which they leave the cell. By using a dye called phthalocyanine, which absorbs not only visible light but also infra-red wavelengths, Dr Grätzel has been able to raise the efficiency of the process to 11%. That, he says, should be enough to make dye-sensitised cells competitive with silicon.



The third technique, being developed by Prashant Kamat of the University of Notre Dame, Indiana, and his colleagues, uses that fashionable scientific tool, the carbon nanotube. This is a cylinder composed solely of carbon atoms, and one of its properties is good electrical conductivity. In effect, nanotubes act as wires a few billionths of a metre in diameter.

Dr Kamat and his team covered the surface of an experimental cell made of cadmium sulphide, zinc oxide and titanium dioxide with nanotubes, so that the tubes stuck up from the surface like hairs. The tubes then eased the passage of the liberated electrons from the cell to the electrode that collected them. Using this technique doubled the efficiency of Dr Kamat's cell from 5% to 10% at ultraviolet wavelengths and he reckons it would create similar increases in efficiency in both plastic and dye-based cells.

Such a boost would take novel solar cells closer to becoming a commercial reality. And that would be a very good thing. Production of solar cells has increased by 32% a year, on average, for the past decade and jumped by 45% in 2005. That sounds impressive, but it has been achieved largely by subsidies from the governments of Germany, Japan and California. Only in places unconnected to an electricity grid, such as much of rural Africa and rural Asia, are solar cells truly commercially viable. But if the price were to come down because efficient cells could be made from cheap materials, that could change quickly. The rest of the world would then be able to join the poor of Africa and the rich of California, and generate solar power for itself.

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Geothermal energy

Blowing hot and cold

Sep 14th 2006 | REYKJAVIK
From The Economist print edition

Geologists are getting more juice out of the ground

GOLDILOCKS, the fussy, blonde, larcenous heroine of an English children's story, liked her porridge neither too hot, nor too cold, but just right. Most engineers looking for underground sources of steam to generate geothermal power have similar tastes. If the steam is much colder than 150°C, it will start to condense into water before it can be used to turn a turbine. On the other hand, steam hotter than 400°C, although richer in energy, is harder to find and to handle. Two new projects, however, aim to push back both these limits.

Geothermal power stations tap aquifers heated by contact with hot rocks in volcanic regions—or, in hot but dry spots, they pump water past such rocks to heat it up. The temperature of the steam produced varies, depending on how hot the source is and how much heat it loses on its way to the surface.

Not all geothermal activity is hot enough to bring water to the boil. The Chena hot springs, in Alaska, for example, are just right for bathers, at a porridge-like 43°C, but not much use for traditional geothermal power generation. Even within the spa's wells, the water is only 74°C. Nonetheless, its owners, in conjunction with United Technologies, an engineering conglomerate, have worked out how to generate power from the tepid flow—the coldest ever used in a geothermal plant.

The power station at Chena uses the spring water to heat up R134a, a fluid hitherto employed mainly as a refrigerant. Since R134a has a relatively low boiling point, the water is hot enough to convert it into a gas. This gas is used to drive the turbine just as steam would be. Icy water from a nearby river then cools the gas back to liquid form, to start the cycle again.

The idea of using a liquid with a lower boiling point than water to drive a turbine is nothing new—it has simply not proved worthwhile in the past. It is the thermal energy of the gas, after all, that the turbine converts into electricity, so the colder the gas, the lower the yield. Such low yields, in turn, do not normally justify the cost of construction.

The designers of the plant at Chena, however, managed to slash their capital outlay by substituting mass-produced parts from air-conditioners for the bespoke components of most geothermal plants. They reckon their design could be mimicked anywhere there is a difference in temperature of at least 50°C between heating and cooling water. That would apply not only to a huge number of geothermal sites, but also to many oil wells, which often bring up warm water from great depths along with their more valuable output.

In Iceland, meanwhile, a consortium of utilities is teaming up to do just the opposite: harness steam that is much hotter than the norm. The wells of most geothermal plants are about 2km (a mile-and-a-bit) deep. But the Icelandic outfit hopes to drill to depths of 4km or more, to get closer to the magma that rises towards the surface along local faultlines. In such areas, geologists predict, the steam might be as hot as 600°C.

Tapping this steam would be expensive, since it would require not only extra building materials, but also more durable ones, to cope with the higher pressures and temperatures. But Olafur Flovenz, of Iceland Geosurvey, believes that although the costs might double or triple, the amount of electricity generated could rise by as much as ten times. As it is, power-hungry industries are flocking to Iceland to take advantage of the cheap electricity generated by geothermal plants. If the “Iceland Deep Drilling Project” succeeds, it would bring the costs down even further. Better yet, it could be replicated in any country with a volcano.

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About sponsorship

Novel antibiotics

Jamming the signal

Sep 14th 2006 | SAN FRANCISCO
From The Economist print edition

Blocking bacterial communication may help to fight infections

BACTERIA communicate with their neighbours through chemical signals. They use the information thus gathered to direct their behaviour, working as individual cells when they are at low density and then switching to more collaborative group behaviour at higher densities. It is when they are hunting as a pack that bacteria are particularly dangerous, for it is then that disease-causing microbes become powerful enough to attack living tissue and to fend off many sorts of antibiotic that would kill them individually.

A number of chemists are looking for ways to jam this “quorum sensing” system with modified versions of the bacteria's own chemicals that will gum up the receptors for these signals. In particular, they hope to break down the collective defence against antibiotics. One group, led by Helen Blackwell, of the University of Wisconsin, Madison, has just reported its latest results to the American Chemical Society meeting in San Francisco.

Dr Blackwell studies a group of quorum-sensing molecules called acylated homoserine lactones (AHLs). Many bacteria secrete AHLs, and simultaneously absorb them from their surroundings. As more bacteria grow in an area, the amount of AHL increases, eventually reaching a concentration high enough to trigger behavioural changes. For example, when a pathogenic bacterium called *Pseudomonas aeruginosa* reaches a quorum, it starts to produce molecules called virulence factors that damage the cells of its host, liberating their contents so that the bacteria can feed. The bacteria also band together tightly in response to the appropriate AHL, and secrete a protective layer of complex sugar molecules that protect them from their surroundings. The result, known as a biofilm, is the source of many hospital-based infections, since biofilms are impervious to antibiotics.

Dr Blackwell's group has built up “libraries” of several hundred AHLs, and has been screening them in laboratory cultures to test their effects on various species of bacteria. One aim of this screening is to find compounds that block communication in some species but leave others undisturbed. That is important, because not all bacteria that live in people are harmful. Indeed, some are beneficial.

But stopping communication in a Petri dish is not the same as blocking it in a bacterium's natural environment. To find out if the new compounds can alter the course of infection in an animal, Dr Blackwell's group infected some cabbage white butterfly caterpillars with *P. aeruginosa*. Some of the caterpillars also received what she hoped was an appropriate AHL. After a week, nearly all of the animals infected with the bacteria alone were dead, whereas half of those that had been treated with the AHL survived.

The new compounds are not yet ready for testing on people, according to Dr Blackwell. The dose rate needed to make them work in insects would be too much for people to tolerate, so some more design work is necessary. But if that can be done successfully, her first experiment will be to see—initially in mice—whether they can prevent burns from becoming infected.

Nor is suppressing bacteria the only possible use of AHLs. In at least one bacterium, Dr Blackwell and her fellow researchers are working on a way to turn up the volume instead of turning it down. Leguminous plants, such as peas and beans, rely on bacteria in their roots to “fix” atmospheric nitrogen into ammonia. Plants use this ammonia to make proteins. However, bacteria fix the gas only when their population is high enough to trigger the quorum-sensing machinery. One compound synthesised by Dr Blackwell's team is more effective than the natural signalling chemical at turning on this group behaviour—and works even when there are not enough bacteria around to induce the process naturally. Who could have guessed that bacteria would listen so well?

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About sponsorship

Endogenous retroviruses

Love thine enemy

Sep 14th 2006
From The Economist print edition

A virus has been subverted into helping its host

VIRUSES are nasty things. Even the most benign are parasites, draining the resources of their hosts. The less benign can cause lethal diseases. But evolution is ever resourceful, and in one case it has found a way to harness a viral gene for the host's benefit. A paper just published in the *Proceedings of the National Academy of Sciences*, by Kathrin Dunlap of Texas A&M University and her colleagues, shows that this gene plays a vital role in the development of some embryos. The gene in question belongs to a retrovirus and the embryos in question belong to sheep. But Dr Dunlap's work has implications for other mammals, including people.

The hereditary material of a retrovirus is a molecule called RNA, which is similar to, but distinct from, DNA. At one point in a retrovirus's life-cycle its RNA is copied into DNA and that DNA is lodged in the host cell's nucleus. If that host cell is a sperm or egg cell, or the precursor to such a cell, then the lodged DNA may get passed down the generations. If so, the result is known as an endogenous retrovirus.

It has been suspected for some time that endogenous retroviruses are involved in the process by which an embryo attaches itself to the lining of the womb. Dr Dunlap has shown, in sheep, that they definitely are—and has confirmed which gene is involved. This gene is known as *env*, and in free-living viruses the protein derived from it is responsible for locking on to a cell's surface to allow the virus to enter the cell. In sheep, though, the gene seems to be involved in establishing the placenta that nourishes the embryo.

The way Dr Dunlap found this out was by stopping *env* working. She did so using a biological gizmo called a morpholino. This is an artificial molecule that binds to and disables the molecular messengers a gene sends out into the cell it inhabits, to tell that cell how to make the protein that the gene encodes.

Having created a morpholino for the *env* messenger molecule, Dr Dunlap injected it into a series of ewes eight days after they had mated and sat back to see what would happen. Half the ewes were examined 16 days after mating (ie, eight days after the treatment) and the other half 20 days after mating.

At 16 days, the embryos and their associated membranes in the treated sheep were much smaller and more fragile than those of ewes that had been injected with morpholinos that do not interfere with *env* messengers, and were being used as controls. By the 20th day after mating, almost all the treated ewes had lost their embryos, but none of the controls had.

These effects were probably the result of some biochemical changes Dr Dunlap saw in the treated ewes. Their levels of a hormone called interferon-tau were far lower than normal. This hormone is produced by the embryo to tell the mother she is pregnant and that she should continue producing progesterone, a second hormone responsible for maintaining the pregnancy. Levels of two other hormones associated with pregnancy—chorionic somatomammotropin and pregnancy-associated glycoprotein—were also far lower than they should have been.

How the retroviral *env* gene has these effects is not clear. But what is more curious is this: the retrovirus is closely related to a free-living virus called Jaagsiekte sheep retrovirus, which causes lung cancer in sheep and goats, but not other species. That is not surprising in itself, but it means that the virus must have become endogenous fairly recently, otherwise it would not look so similar to its free-living counterpart. However, circumstantial evidence suggests that rodents (in the form of mice) and primates (in the form of both monkeys and humans) have also acquired endogenous retroviruses that help placenta formation, and have done so independently of what happened in sheep. Clearly, this retroviral gene fills an important niche in mammalian biology, but, on the other hand, mammals were able to reproduce perfectly well before they were first infected. That, too, is weird. Nevertheless, without the

retrovirus's presence now, you might not have been born.

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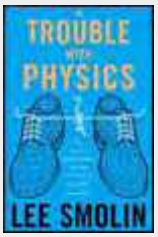
Theoretical physics

All strung up

Sep 14th 2006
From The Economist print edition

String theory has dominated theoretical physics for the past 20 years—to the detriment of science, say two new books

The Trouble with Physics: The Rise of String Theory, the Fall of a Science, and What Comes Next
By Lee Smolin



Houghton Mifflin; 416 pages; $26.
To be published in Britain by Penguin/Allen Lane in February 2007

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Not Even Wrong: The Failure of String Theory and the Search for Unity in Physical Law
By Peter Woit

Basic Books; 304 pages; $26.95.
Jonathan Cape; £18.99

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IT IS almost a century since Einstein did his finest work; more than 30 years since theoretical physicists developed the standard model that describes the basic building blocks of nature. Not a lot has happened since, despite the best efforts of thousands of theorists and the expenditure of hundreds of millions of dollars. Two new books blame string theory.

String theory is an attempt to unify two fundamental ideas in physics—quantum theory and general relativity—by building everything in the universe from tiny strings and membranes existing in 10 or 11 dimensions. The theory has been the dominant area of research in theoretical physics for the past 20 years. Unfortunately its promise remains unfulfilled. As yet, string theory has made no predictions that could prove it to be wrong. Since being falsifiable is one of the tests of what constitutes a science, Lee Smolin and Peter Woit have come to the conclusion that string theory is unscientific; not only that, they regard it as mere conjecture and unworthy of being called a theory at all.

Another reason for denouncing string theory is that there are so many different versions of it—and no way of telling which is right. Moreover, when an unexpected discovery has come to light, string theory has had to be adapted so that it incorporates what has already been seen to be true. Such is its malleability that Mr Woit repeats a phrase which some attribute to Richard Feynman, “String theorists don't make predictions, they make excuses.”

There is worse. As string theory has become more mathematically elaborate, its practitioners have begun to manipulate it as though experimental verification were unnecessary. This is complicated by the so-called anthropic principle. In recent years some of the brightest theorists have argued that the very presence of humans in the universe indicates which of the many string theories is valid—namely, those that allow the universe to exist as observers see it. Most scientists outside the string theory community are philosophically uncomfortable about this. Science, they say, makes predictions that are then confirmed by experiment. The anthropic principle abandons this logic. As Mr Smolin puts it, “I find it unfortunate that [many] have embraced the anthropic principle, because it has been understood for some time that it is a very poor basis for doing science.”

However, the biggest problem, both authors believe, is that string theorists have promoted their subject aggressively, often taking the best jobs in universities and blocking the advancement of physicists who would seek to use other means to unify the laws of physics. As string theory involves intricate mathematics, the barrier to entry into its community is high. The very difficulty in overcoming this barrier makes it hard for those who have gained entry to leave. The self-interest of string theorists is thus stifling physics.

“The Trouble with Physics” by Mr Smolin, a theoretical physicist at the Perimeter Institute in Waterloo, Ontario, is the more pleasurable of the two books. The author comes across as charming and charismatic, and he tells witty anecdotes, even if many illustrate the same points. His summary of the philosophy of science combined with his account of his personal experiences is useful because it reveals how science is really done.

Mr Smolin argues that the insularity of the theoretical physics community leaves it vulnerable to “groupthink”, a term coined to explain how many intelligent like-minded people can nevertheless be catastrophically wrong. But his suggestions as to how science might progress seem a little wayward, particularly the view that science needs visionaries rather than mathematically adept plodders (he sees himself as the former, by the way).

Mr Woit, a mathematician at Columbia University, started his book as a blog. His “Not Even Wrong” is the braver book, for he is a relatively lowly worker in the scientific hierarchy compared with the fine minds he attacks. Sadly the first half is a dull and, in places, inadequate history of particle physics. The second half is better, albeit prefaced with the warning, “Readers who like their science always to be inspirational are advised that now might be the time to stop reading this book.” Actually this is a good place to start reading for it is here that Mr Woit shines. He differs from Mr Smolin in seeing more merit in theories that are beautiful, whereas Mr Smolin puts more emphasis on experimental tests. Yet string theory appears inelegant to Mr Woit. He explores the interface between maths and physics, concluding that mathematicians view string theory as physics and physicists regard it as mathematics. The two communities are at odds over whether string theory is a series of abstract puzzles or whether it says something about the real world.

The idea that beauty can point to scientific truth served Einstein well. Sadly for science, it may have misled a later generation of theoretical physicists.

The Trouble with Physics: The Rise of String Theory, the Fall of a Science, and What Comes Next.
By Lee Smolin.
Houghton Mifflin; 416 pages; $26.
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New fiction

Desert storm

Sep 14th 2006
From The Economist print edition

WITH its Old Testament self-importance, its predictable tics and often redundant phrasing (“The snow fell nor did it cease to fall”), Cormac McCarthy's “The Road” may seem grating at first. Nevertheless, his story of an unnamed father and son after an unnamed Armageddon, shambling ever southwards in an unnamed country, gradually conjures a compelling and memorable dread.

The post-apocalypse novel, usually but not always the province of science fiction, is intrinsically mournful. Normally, there is a skewed social structure through which, at least in pockets, humanity has regrouped. “The Road” has no reconfigured society beyond a few roving bands of cannibals. The father's fierce loyalty to his son is all that is left of Rotary Clubs, democratic elections and supermarkets. The duo scavenges stray tins of peaches from houses largely looted years before, but clearly the tinned goods will soon run out altogether.

The opening's pretentious intonations give way to passages that are wrenchingly elegiac: “Perhaps in the world's destruction it would be possible at last to see how it was made. Oceans, mountains. The ponderous counterspectacle of things ceasing to be.” In the incinerated cities, “The melted window glass hung frozen down the walls like icing on a cake.” And single plot twists chill the blood. Followed by a small band of raggedy travellers, including a woman who is pregnant, the father frightens the group into abandoning camp. There, the two find a human infant blackening over the fire on a spit.

Mr McCarthy brutishly portrayed the American West in his last novel, “No Country for Old Men”. Yet here he encourages gratitude for even that compromised world of heroin dealers and human trafficking. When “the man” discovers a brass sextant carefully preserved in a baize-lined case, “He is struck by the beauty of it,” and so is the reader. Under Mr McCarthy's bleakness burns a retroactive treasuring. To wit, even with rising oil prices, terrorism and insurgencies in Afghanistan and Iraq, there may come a time when readers look back in wonder that they ever had it so good.

The Road.
By Cormac McCarthy.
Knopf; 256 pages; $24.
To be published in Britain by Picador in November

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By Cormac McCarthy

Knopf; 256 pages; $24.
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About sponsorship

The Bloomsbury set

Life at the edge

Sep 14th 2006
From The Economist print edition

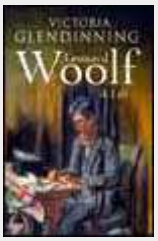
LEONARD WOOLF features in every book on the Bloomsbury group. There he is with his long, lined face, his thatch of hair, his lean figure in a tweed suit—the ever-present husband of Virginia Woolf. Is it possible that another fat Bloomsbury biography is required? And one, to boot, of a spouse or consort?

Woolf outlasted most of that close-knit circle, not only his wife, but also her sister, Vanessa Bell, Lytton Strachey and John Maynard Keynes, dying in August 1969 at the age of 88. Virginia had thrown herself in the river Ouse 28 years earlier. His life, so far, has been defined by hers.

The strain of living with Virginia, attempting to keep her calm and balanced, was immense. The severity of her mental collapses had been evident from the very start of the marriage, and Leonard was on suicide watch from the outset. They were devoted for 29 years; there was no sex.

Woolf was born into a large, well-established London Jewish family. His father was a QC who died young leaving his widow with nine children which forced a move from a big house in Kensington to a cheaper borough. Virginia was relentlessly scathing about his family and unhelpful with them. Indeed, Leonard had to contend with a pervasive low-level anti-Semitism, common among the upper middle classes then; he developed what he called his “carapace”.

Leonard Woolf: A Life
By Victoria Glendinning



To be published in America by Free Press in November Simon and Schuster; 530 pages; £25.

Buy it at
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Amazon.co.uk

At Trinity College, Cambridge, Woolf straight away fell in with Strachey, Thoby Stephen (Virginia's brother) and Clive Bell (who would later marry her sister, Vanessa), the core of the future Bloomsbury set. Several of them, including Leonard, became members of the Cambridge Apostles, an exclusive society which met to discuss ideas, and which had, then, under Strachey's influence, a strong gossipy homoerotic flavour. Leonard, however, was not gay.

After Cambridge, his life diverged from those of his friends. He joined the Colonial Service and was sent to Ceylon, as it then was. Seven years of working for the British empire, dishing out British justice, punctilious in administration, gave him a broader perspective on life. He is remembered to this day in Sri Lanka where his novel about his time there, “The Village in the Jungle”, has never been out of print.

Marriage to Virginia in 1912 put a stop to his continued service in the tropics as it was clear that she could not have coped. Indeed, her fragility together with some health problems of his own exempted him from fighting in the first world war. His life thereafter was politics within the early Labour party; he was a prolific political journalist and theorist, author of many books, joint editor of *Political Quarterly*, a long-term contributor to the *New Statesman* and an unflagging member of innumerable political committees.

Woolf is better known for the Hogarth Press, a small printing operation which began as a hobby for both him and Virginia with a handpress in the dining room of their house. Such were their connections that it grew rapidly into a distinguished publishing house and included T.S. Eliot, Sigmund Freud, and E.M. Forster among its authors.

Greater happiness awaited him after Virginia's death, in particular with Trekkie Parsons, whom he appeared to share with her husband, Ian. Woolf was clever and wise but could be harsh and irritating. He had some surprising facets to his character—a great fondness for animals (at one time he owned an adored marmoset, Mitz)—along with a very competitive streak and a love of gardening and growing prize-winning vegetables. He had from early days a hand tremor.

Victoria Glendinning, a most experienced British biographer, has, yes, proved the case for yet one more Bloomsbury biography. By piecing together minutely snippets from diaries and letters and from Woolf's own five volumes of autobiography, by including daily domestic matters while never ignoring the social and political context, she has constructed a meticulous but vivid portrait, though on occasion the abundance of material threatens to overwhelm. And although there is something cheerless about Bloomsbury, it is illuminating to perceive it from his standpoint, the partial outsider, and to watch Virginia with a husband's eyes. The tension in the build-up to her death and the agony of the three weeks' wait until her body was found are palpable.

Leonard Woolf: A Life.
By Victoria Glendinning.
Simon and Schuster; 530 pages; £25.
To be published in America by Free Press in November

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About sponsorship

New cinema

Deconstructing the Dahlia

Sep 14th 2006 | LOS ANGELES
From The Economist print edition

Two mysteries and a revelation loom in Brian De Palma's new thriller

TWO Hollywood mysteries lie at the heart of “The Black Dahlia” by Brian De Palma. The first is the unsolved murder of Elizabeth Short, a young woman whose dismembered body was found in a vacant lot in Los Angeles on January 15th 1947.

The other mystery is artistic: can James Ellroy's Los Angeles novels, with their symphonic plots and Dostoyevskyan cop protagonists, be adapted to the screen? One of them, “LA Confidential”, was filmed to wide acclaim, but only after its corrupt anti-heroes had been whitewashed for mass consumption. Now Mr De Palma proposes his solution to the problem with this adaptation of the novel that cemented Mr Ellroy's literary reputation.

Like many cinematic failures, “The Black Dahlia” is really two films. It starts off solidly enough, focusing on a romantic triangle composed of two homicide detectives, Bucky Bleichert (Josh Hartnett) and Lee Blanchard (Aaron Eckhart), and the latter's girlfriend Kay (Scarlett Johansson, pictured above). After a coincidence places the detective duo on the scene when Short's body is found, Lee becomes so obsessed with solving the murder that his friends grow worried.

But instead of following his investigation, the viewer is offered Bucky's adventures with decadent rich girl Madeleine Linscott (Hilary Swank), who knew the murder victim, and Madeleine's Raymond Chandleresque family, which has its own secrets.

After an unexpected homicide at the halfway point, both films fall apart. Mr De Palma, the master of flashy pseudo-Hitchcockean sleight of hand, cannot sustain the illusion that the characters in the love story are real. And when Bucky finally solves the case, “The Black Dahlia” unravels faster than its plot, becoming a post-modern parody of Chandler that recalls the outlandish endings of earlier, less ambitious De Palma films.

At least there are two dazzling sequences—one involving the discovery of the body, the other set in a lesbian nightclub—and a revelation. Mia Kirshner gives a memorably weird performance as Elizabeth Short in scenes from a black-and-white screen test that the investigators keep re-running. Why is an actress who can steal a picture from Ms Swank and Ms Johansson being wasted on television?

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About sponsorship

King Charles I

Heading off

Sep 14th 2006
From The Economist print edition

GRANTED, the competition isn't strong. But England has never had a cleverer line of monarchs than the 17th-century Stuarts. Nor one more foolish, as apt to harm themselves as the nation they misruled: four civil wars provoked and lost; two crowns lost and one crowned head. Still they did the nation—and, as time showed, the monarchy—one real favour. If most later sovereigns have used their heads more wisely, it was not least because Charles I lost his.

The hero of this lively biography, which was published in Britain a year ago and is just out in America, is the lawyer who, in his field, did most to execute the king: John Cooke, who prepared the case for trial in 1649, and was savagely punished for it after the monarchy was restored in 1660. Cooke's name is barely a footnote in histories of the time. With men like Augusto Pinochet, Slobodan Milosevic and Saddam Hussein in mind, Geoffrey Robertson, an international lawyer, is eager to write it six feet high.

The trial never really became one: Charles, accused of high treason and much else, refused to plead, denying the court's authority. He had a point. The court was set up, without the king's consent or the Lords', by the House of Commons alone; a house from which many members had been forcibly ejected in “Pride's purge”. But Mr Robertson will have none of this. As the de facto power-that-was, he argues, even this truncated Commons was entitled to create the court.

The Tyrannicide Brief: The Story of the Man Who Sent Charles I to the Scaffold
By Geoffrey Robertson

Pantheon; 448 pages; $30. Chatto and Windus; £20

Buy it at
Amazon.com
Amazon.co.uk

So Cooke himself argued, vainly, at his own trial in 1660. Anyway, he added, he had only done his duty as a lawyer: he had been given a case and he had to argue it as best he could. Factually, this was thin: a lawyer maybe, but one wholly in sympathy with his case. His plea anyway fell on plugged ears. Yet history has backed him: the “cab-rank” principle that a barrister must take any brief he is offered is today commonplace, if not always a fact. And no one disputes that, having taken it, he must argue for his client as best he can.

History also backs Cooke on the substantive issue. Had Charles deigned to plead, he would have argued, as Cooke's prosecutors did in 1660, that “the king can do no wrong”. If wrong were done, even at his command, his ministers could be punished, but not the monarch, accountable only to God. To modern ears this is absurd. To the 17th century its truth was self-evident. Not to Cooke and the Commons: the divine right of kings, which Charles had imbibed at his father's knee, was myth. The king was not above the law. The “rump” Commons indeed went much further still: “the people under God are the organ of all just power”, and the Commons, representing them, the supreme authority, entitled to make law whether king or Lords consented or not.

In practical terms, Charles was indeed guilty. At least the second civil war was of his sole and unscrupulous making. He had conspired to bring in Scottish, Irish and even French soldiery to aid him. Lawfully or not, Cooke and the court of 1649 gave him what he deserved. From then on, Cooke, seemingly successful, was in practice a loser. He went to Ireland, and did his personal best to ensure that justice be both just and speedy. But the reforms of legal sloth and chaos that he tried to institute there and hoped to see take root in England too were frustrated. Then came the Restoration.

Having said he did not seek revenge, Charles II named 49 “regicides” as due for it. All who could be found were set before a kangaroo court, “tried” for a few hours, and duly found guilty by a jury that seldom bothered even to retire. Some escaped death. Cooke was one of ten sentenced to be hanged, drawn and quartered, a revolting medieval procedure that his executioner dragged out as long as

possible. And until 1859 the Church of England delivered sycophantic prayers in memory of Charles I, “the Martyr”.

The Tyrannicide Brief: The Story of the Man Who Sent Charles I to the Scaffold.
By Geoffrey Robertson.
Pantheon; 448 pages; $30.
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About sponsorship

The Green Vault

Time machine

Sep 14th 2006 | DRESDEN
From The Economist print edition

Augustus the Strong's treasure hoard together at last

IN 1942 some of the greatest artefacts of the German Baroque were taken from the Green Vault in Dresden, where they had been displayed barring a few interruptions since 1732, to Fortress Königstein 30 kilometres (19 miles) away. Wonderful works in ivory, jewellery, silver and gold thus escaped the Allied bombing of February 13th 1945 which devastated the city. But three months later a victorious Red Army carted them off to Russia.

By a miracle of Soviet diplomacy the whole lot—including Ivan the Terrible's solid gold drinking bowl—was returned to communist Dresden in 1958. Some of the pieces have been on show since 1974, and two years ago 1,000 of the best works were given a new home on the first floor of the schloss which is the centrepiece of an increasingly sumptuous baroque city. But it has taken nearly half a century for 3,000 more pieces to be put on display one floor below, in the original Green Vault.

Hidden charms

The Historic Green Vault—not to be confused with the two-year-old New Green Vault upstairs—has been lovingly restored in every detail. Visitors today are taken, five at a time, to another world in space and time. This is almost exactly what the nobles and other paying guests to Augustus the Strong's treasury would have seen 274 years ago.

The vivid vermilion walls in one room and the malachite green of another have been matched molecule for molecule with the originals. So have the mercury-backed mirrors which softly reflect only 60% of the light. The only concessions to modernity are the electric lighting, and a combination of non-reflective glass and infra-red beams to protect the exhibits.

It is not just a stunning display of opulence and craftsmanship—the New Green Vault upstairs is the place for that—but also like being on stage in a Baroque opera without the music. The number of visitors is limited, and tickets are booked months in advance, though early birds can queue for the small quota of tickets that is sold on the day.

The opera progresses, from a barely lit chamber laden with amber, to one of ivory, then silver and silver-gilt—do not miss a silver-gilt plate by Elias Geyer, from which two horses literally prance from a hunting scene—to the *pièce de resistance*, a vaulted chamber of 200 square metres, dubbed the Pretiosa room. The mirror-clad columns, hiding the original green which once gave the vault its name, the gilded mouldings, the full-length princely portraits let into each window bay showing off the thickness of the castle walls, are a backdrop for hundreds of artefacts, cabinets, carvings in rock crystal, extravagant coffee sets, bejewelled nautilus shells and ostrich eggs. The highlight is the “Throne of the Great Mogul”, a tableau in miniature, by one of Dresden's greatest designers, Johann Melchior Dinglinger. There are more of his works upstairs, including the astonishing “Throne of Aureng-Zeb”.

Next is a sobering panelled room devoted to coats of arms in metal, some of them reduced to scorched fragments in the firestorm of 1945. Then a room of sumptuous gems—whole cases of rubies, emeralds, sapphires, carnelians and diamonds set into brooches, buttons, epaulettes and swords. (Dresden's

legendary green diamond is upstairs.)

Two final rooms of Baroque and Renaissance bronzes complete the tour. There is a small but imposing equestrian statue of Augustus the Strong, elector of Saxony and king of Poland, who built the Green Vault in the 1720s, inspired by youthful trips to Versailles, where he sat at the feet of the Sun King, Louis XIV; Florence, where he saw the Medici treasures in the Uffizi Palace; and Vienna, home of the Habsburg Schatzkammer.

Without the dedication of two and a half generations of restorers the Green Vault would just be history. Overall, the collection has led a charmed life: several times before 1942, during the second Silesian and the Napoleonic wars it was packed up and stored at Königstein. There have also been less fortunate moments: the silver, and most of the silver-gilt, was melted down in 1772 and made into coin. The jewellery was pawned twice in Amsterdam to pay for various wars and each time redeemed at a punishing premium.

Today, Dresden is beginning to vie with Paris, St Petersburg and Vienna as a centre of Baroque pomp. The Frauenkirche, rebuilt from mere rubble, was opened last October, and the now-complete Green Vault is another jewel in the crown.

Tickets to the Historic Green Vault can be booked online at www.skd-dresden.de or by telephone at +49 (0) 351 49 19 22 85

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About sponsorship

Gyorgy Faludy

Sep 14th 2006
From The Economist print edition

Gyorgy Faludy, the voice of Hungarian resistance, died on September 1st, aged 95

EPA

DEPRIVED of pen and ink in Hungary's Stalinist concentration camp, Gyorgy Faludy used a broom-bristle to write in blood on toilet paper. Suffering, he once said, was not a virtue. But his three years at Recsk, from 1950 to 1953, were in a way darkly inspiring. Mr Faludy's best-known work outside Hungary, a prose account of his time in the camp, was called “My Happy Days in Hell”.

In a sense Mr Faludy chose prison. He was offered the chance to flee to Austria but refused, arguing that he must bear witness to whatever horrors the communists could dream up. In “Ode for Stalin's 70th Birthday”, he listed the fates reserved for the brave: kickings with jack-boots, bullets to the head, the gallows. Inevitably, it was not long before he was arrested himself.

His body was imprisoned, but his mind was not. “Starved and frozen,” he wrote, “I huddled on the stone floor, making a sort of tent of my verminous coat, breathing into a sleeve to warm my body and made poems all day long.” When a guard showed him his nephew's verses, Mr Faludy sardonically dismissed them as decadent and counter-revolutionary. The guard paled.

Held in Recsk's tiny, dark punishment cell, Mr Faludy spent hours transfixed as a ray of winter sunlight moved across the floor. He imagined himself in the South Seas. He and his fellow inmates ran an ad-hoc university, teaching poetry, history and literature. One prisoner whistled the whole of Mozart's “Don Giovanni”, another recounted “War and Peace”. Mr Faludy made his colleagues memorise his verses as he wrote them. If one was released, he would visit Mr Faludy's wife Zsuzsa and dictate the verses to her.

He was released in 1953, when Stalin died and Recsk closed. But the camp never left him. It reappeared, for example, in a poem of 1983.

> Learn by heart this poem of mine,
> Books only last a little time,
> And this one will be borrowed, scarred,
> Burned by Hungarian border guards,
> Lost by the library, broken-backed,
> Its paper dried up, crisped and cracked,
> Worm-eaten, crumbling into dust,
> Or slowly brown and self-combust,
> When climbing Fahrenheit has got
> To 451, for that's how hot

it will be when your town burns down.
Learn by heart this poem of mine

He had opted for poetry early, seduced by Budapest's cafés and literary life, but his scientist father would have none of it. Budapest already had 20,000 poets, he said, none of whom could support themselves. The young Faludy was packed off to Vienna to study chemical engineering. He remained unknown to his professors, publishing instead the translations of François Villon, a rebellious 15th-century French poet, that launched his literary career. He also wrote a poem against Hitler that would have earned him 14 years in prison, but he was tipped off and escaped. He fled Hungary in 1938 for France and, when war broke out, took a boat to Morocco, finding eventual sanctuary in the United States and enlisting in the American army.

Typing with finches

He came back to Budapest after the war to observe, as he put it, “democracy being built without democrats”. In October 1956, when Hungary exploded against Soviet occupation, Mr Faludy was in the thick of it, as a delegate from the Writers' Association to the workers' councils that ran much of the revolution. But when the Soviet tanks rolled in he fled west again: to Vienna, Florence, Malta, New York and Toronto, where he set up home with an American dancer called Eric Johnson.

The handsome young man had tracked him down in Malta after reading “My Happy Days in Hell”. Mr Faludy was living there after his wife died. He fell hard for Eric, writing sonnets to him. In Toronto they shared a tiny apartment with a pair of finches; the birds would perch on Mr Faludy's typewriter, flying up each time the bell signalled the end of another line.

For more than 20 years, until 1989 when Communism fell, Mr Faludy stayed in Canada. He at last returned home, his books unbanned after four decades, to live in a spacious flat overlooking the Danube given to him by the city authorities. There, he went on shocking people. He dumped Eric for a lissom poetess more than 60 years his junior, married her and appeared with her, almost naked, in the pages of the Hungarian edition of *Penthouse* magazine. With his shoulder-length mane of white hair and piercing brown eyes, he looked like a biblical prophet—though, with Fanny, he hardly behaved like one.

She was far from the first. We lay there naked,
And, with one arm, I lightly caressed her body.
I hope it should be quite agreeable,
With just a touch of customary boredom.
It turned out to be more. I leaned above
Her small left nipple musing what to
Compare it with: a speck of coral? Or a wild strawberry
A tiny tulip still in bud perhaps

Revered by his compatriots, showered with prizes and honours, he wrote until the end. His last collection, published in 2003, was called “Stormy Century”. He often stayed up until the early hours, watching the Danube flow by like the pulse of poems in his blood.

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Overview

Sep 14th 2006
From The Economist print edition

America's trade deficit in goods and services reached a record $68 billion in July, rising by 5% from the month before. Exports declined by $1.3 billion in the month, to $120 billion, while imports increased by $1.9 billion, to $188 billion. However, America's biggest bilateral deficit, with China, shrank: to $19.6 billion from $19.7 billion. The recent slide in the price of crude oil could narrow the trade deficit in the coming months.

Mortgage applications in America increased by 3.2% during the first week in September, according to the Mortgage Bankers Association. The demand for loans to buy homes had eased, but has bounced back a bit after a decline in the cost of borrowing.

In **Japan** core orders for machinery, which exclude those from shipbuilders and electricity companies, fell by 16.7% in July. It was the sharpest decline in almost 20 years, suggesting that investment spending may weaken. However, Japan's GDP grew by 0.2% between April and June—or by 1.0% at an annualised rate. Japanese wholesale prices increased by 3.4% in the year to August on the back of expensive oil and raw materials. The Cabinet Office's index of consumer confidence in Japan declined to 47.6 in August from 48.6 the month before.

In **Britain** prices rose beyond expectations last month, as annual inflation increased to 2.5%, from 2.4% in July. Inflation has now been above the Bank of England's 2% target for four months, raising the possibility that interest rates will rise this autumn. In the three months to July, average earnings were 4.4% higher than a year earlier, the fastest increase for more than a year.

France's consumer-price index rose by 1.9% in the year to August, the same as July. On the European Union's harmonised measure, inflation eased a bit, from 2.2% to 2.1%. French industrial production fell by 1.3% in July: forecasters had expected a slight increase. Carmaking declined by 1.4%, consumer-goods production dropped by 0.6% and the output of capital equipment fell by 0.4%.

Industrial production in **Germany** beat expectations in July, rising by 1.2% from the previous month and 4.7% from a year earlier on the back of growth in construction and spending on household appliances. The construction sector gained 3.4% in July, whereas manufacturing output increased by 1.2% and energy dropped by 0.5%.

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Output, demand and jobs

Sep 14th 2006
From The Economist print edition

% change on year ago

	GDP latest		GDP qtr*	The Economist poll GDP forecasts 2006	2007	Industrial production latest		Retail sales (volume) latest		Unemployment % rate latest		year ago
Australia	+ 1.9	Q2	+ 1.3	+ 3.2	+ 3.3	– 1.0	Q1	+ 3.6	Q2	4.9	Aug	5.0
Austria	+ 3.0	Q2	+ 3.6	+ 2.4	+ 1.9	+ 6.2	Jun	+ 0.9	Jun	4.8	Aug	5.3
Belgium	+ 2.8	Q2	+ 3.2	+ 2.6	+ 1.9	+ 3.7	Jul	– 1.6	Jun	13.0	Jul†	13.4
Britain	+ 2.6	Q2	+ 3.4	+ 2.6	+ 2.5	– 0.5	Jul	+ 4.0	Jul	5.5	Jun‡	4.8
Canada	+ 2.9	Q2	+ 2.0	+ 3.1	+ 2.8	+ 0.4	Jun	+ 6.4	May	6.5	Aug	6.8
Denmark	+ 2.4	Q2	+ 7.8	+ 2.7	+ 2.3	+ 5.6	Jul	+ 3.4	Jul	4.4	Jul	5.8
France	+ 2.6	Q2	+ 4.7	+ 2.2	+ 2.0	+ 1.3	Jul	+ 5.5	Jul	8.9	Jul	9.9
Germany	+ 2.4	Q2	+ 3.6	+ 2.0	+ 1.3	+ 4.7	Jul	nil	Jul	10.6	Aug§	11.7
Italy	+ 1.5	Q2	+ 1.9	+ 1.5	+ 1.2	+ 3.6	Jun	– 0.3	Jun	7.4	Q1	7.8
Japan	+ 2.5	Q2	+ 1.0	+ 2.8	+ 2.3	+ 5.1	Jul	– 1.0	Jul	4.1	Jul	4.4
Netherlands	+ 2.4	Q2	+ 4.0	+ 2.5	+ 2.2	+ 1.9	Jun	+ 4.6	Jun	5.4	Jul††	6.7
Spain	+ 3.7	Q2	+ 3.6	+ 3.3	+ 2.8	+ 5.0	Jul	+ 1.1	Jul	7.6	Jul	8.5
Sweden	+ 5.5	Q2	+ 5.6	+ 4.1	+ 2.9	+ 1.5	Jul	+ 7.8	Jul	5.7	Aug†	6.5
Switzerland	+ 3.2	Q2	+ 3.0	+ 3.0	+ 1.9	+ 9.2	Q1	+ 0.8	Jun	3.1	Aug†	3.6
United States	+ 3.6	Q2	+ 2.9	+ 3.4	+ 2.5	+ 4.9	Jul	+ 2.5	Jul	4.7	Aug	4.9
Euro area	+ 2.4	Q2	+ 3.6	+ 2.3	+ 1.8	+ 4.3	Jun	+ 2.5	Jul	7.8	Jul	8.6
MORE COUNTRIES	Data for the countries below are not provided in printed editions of *The Economist*											
Finland	+ 6.6	Q2	+ 7.6	na	na	+12.5	Jul	+ 5.1	Jul	7.7	Jul	8.3
Greece	+ 4.1	Q2	na	na	na	+ 1.4	Jul	+10.1	Jun	9.7	Q1	10.4
Iceland	+ 5.0	Q1	na	na	na	na		na		1.3	Jun†	2.1
Ireland	+ 5.8	Q1	+ 4.4	na	na	+ 8.4	Jul	+ 6.3	Jun	4.4	Aug	4.4
Luxembourg	+ 7.3	Q1	na	na	na	– 1.4	May	– 4.8	Jun	4.1	Jul	4.0
New Zealand	+ 2.1	Q1	+ 2.3	na	na	– 0.7	Q1	+ 0.9	Q2	3.6	Q2	3.7
Norway	– 0.5	Q2	+ 1.9	na	na	– 2.9	Jul	+ 4.4	Jul	3.2	Jul**	4.7
Portugal	+ 0.9	Q2	+ 3.8	na	na	+ 1.3	Jul	+ 4.7	Jul	7.3	Q2†	7.2

*% change on previous quarter at an annual rate. †Not seasonally adjusted. ‡Apr-Jun; claimant count rate 3.0% in Jul.
§EU harmonised rate 8.2% in Jul. ††May-Jul.

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Prices and wages

Sep 14th 2006
From The Economist print edition

% change on year ago

	Consumer prices			The Economist poll consumer prices forecast		Producer prices			Wages/earnings		
	latest		year ago	2006	2007	latest		year ago	latest		year ago
Australia	+ 4.0	Q2	+ 2.5	+ 3.2	+ 2.7	+ 9.9	Q2	+ 6.9	+ 4.7	Q2	+ 5.8
Austria	+ 1.5	Jul	+ 2.3	+ 1.9	+ 1.8	+ 3.9	Aug	+ 0.9	+ 2.7	Jul	+ 2.3
Belgium	+ 1.6	Aug	+ 3.1	+ 2.1	+ 1.9	+ 6.3	Jul	+ 1.9	+ 2.3	Apr	+ 2.6
Britain	+ 2.5	Aug*	+ 2.4	+ 2.2	+ 2.1	+ 2.8	Jul	+ 3.1	+ 4.4	Jul†	+ 4.2
Canada	+ 2.4	Jul	+ 2.0	+ 2.3	+ 2.1	+ 4.3	Jul	– 0.3	+ 0.3	May	+ 1.0
Denmark	+ 2.0	Aug	+ 2.2	+ 2.0	+ 2.0	+ 4.6	Jul	+ 4.7	+ 3.2	Q2	+ 2.9
France	+ 1.9	Aug	+ 1.8	+ 2.0	+ 1.7	+ 3.9	Jun	+ 2.9	+ 3.1	Q2	+ 3.0
Germany	+ 1.7	Aug	+ 1.9	+ 1.8	+ 2.3	+ 5.3	Aug	+ 1.9	+ 1.0	Jun	+ 0.9
Italy	+ 2.2	Aug	+ 2.0	+ 2.2	+ 1.9	+ 6.9	Jul	+ 3.6	+ 3.0	Jul	+ 2.8
Japan	+ 0.3	Jul	– 0.3	+ 0.4	+ 0.8	+ 3.4	Aug	+ 1.8	– 0.3	Jul	+ 2.5
Netherlands	+ 1.4	Aug	+ 1.8	+ 1.5	+ 1.6	+ 5.3	Jul	+ 5.3	+ 1.9	Aug	+ 0.8
Spain	+ 3.7	Aug	+ 3.3	+ 3.7	+ 3.0	+ 6.4	Jul	+ 4.6	+ 3.0	Q1	+ 2.5
Sweden	+ 1.6	Aug	+ 0.6	+ 1.5	+ 1.9	+ 3.7	Jul	+ 3.7	+ 3.8	Jun	+ 3.0
Switzerland	+ 1.4	Aug	+ 1.0	+ 1.3	+ 1.4	+ 2.9	Jul	+ 1.1	+ 1.0	2005	+ 0.9
United States	+ 4.1	Jul	+ 3.2	+ 3.5	+ 2.6	+ 4.2	Jul	+ 4.7	+ 3.9	Aug	+ 2.7
Euro area	+ 2.3	Aug	+ 2.2	+ 2.2	+ 2.1	+ 5.9	Jul	+ 4.1	+ 2.2	Q1	+ 3.2
MORE COUNTRIES	Data for the countries below are not provided in printed editions of *The Economist*										
Finland	+ 1.9	Aug	+ 1.0	na	na	+ 6.0	Jul	+ 4.0	+ 2.9	Q2	+ 3.7
Greece	+ 3.5	Aug	+ 3.7	na	na	+ 7.2	Jul	+ 5.1	na		na
Iceland	+ 7.6	Sep	+ 4.8	na	na	+11.5	Aug	+ 4.3	+10.2	Jul	+ 6.6
Ireland	+ 4.5	Aug	+ 2.3	na	na	– 0.2	Jul	+ 0.2	+ 2.2	Q1	+ 6.4
Luxembourg	+ 2.9	Jul	+ 2.6	na	na	+ 7.3	Jun	+ 6.4	+ 0.7	Jun	+ 2.0
New Zealand	+ 4.0	Q2	+ 2.8	na	na	+ 7.8	Q2	+ 4.7	+ 3.3	Q2	+ 2.6
Norway	+ 1.9	Aug	+ 1.9	na	na	+ 8.8	Aug	+19.9	+ 3.6	Q2	+ 3.8
Portugal	+ 2.3	Jul	+ 2.2	na	na	+ 4.8	Jul	+ 4.1	– 1.5	Jul	– 2.1

*RPI inflation rate 3.4% in Aug. †May-Jul.

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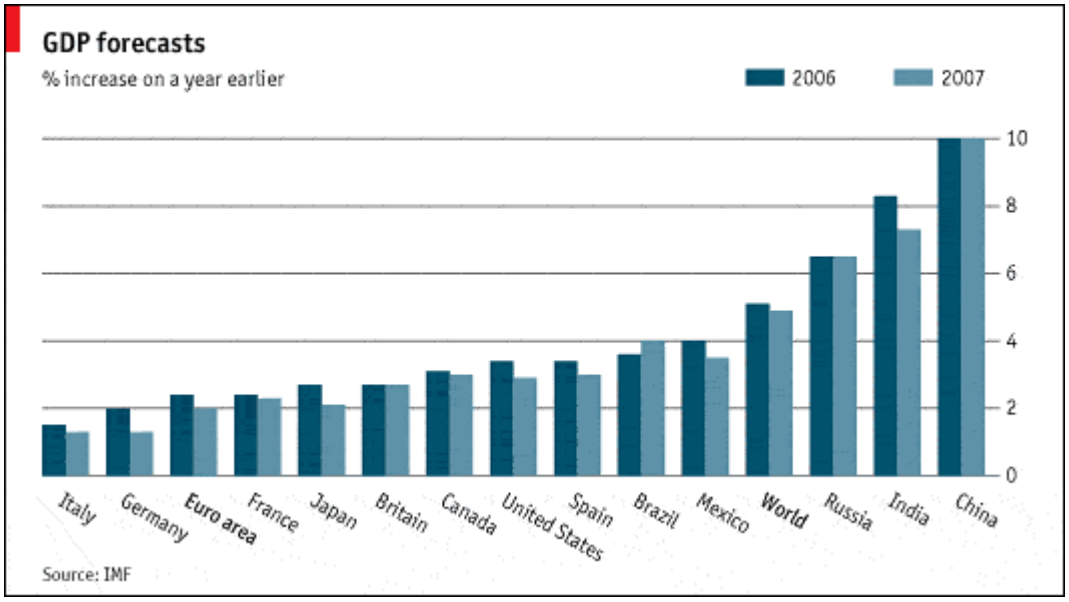
GDP forecasts

Sep 14th 2006
From The Economist print edition



The world economy will grow by 5.1% this year and 4.9% in 2007, according to the IMF's semi-annual World Economic Outlook. America, Japan and Germany will slow the most among the G7 economies. After growing at 3.4%, 2.7% and 2.0% respectively in 2006, they are predicted to cool to 2.9%, 2.1% and 1.3% next year. Japan was the only G7 country where 2006 growth has been revised downwards since the April report.

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Money and interest rates

Sep 14th 2006
From The Economist print edition

	Money supply* % change on year ago			Interest rates % p.a. (Sep 13th 2006)					
				3-mth money market		2-year gov't bonds	10-year gov't bonds		corporate bonds
	narrow	broad		latest	year ago		latest	year ago	
Australia	+ 9.4	+10.4	Jul	6.22	5.62	5.86	5.60	5.15	6.82
Britain	+ 5.4	+13.1	Jul	4.95	4.56	4.92	4.56	4.17	5.65
Canada	+15.5	+ 6.5	Jul	4.15	2.74	4.02	4.12	3.86	5.36
Denmark	+10.3	+ 7.4	Jul	3.30	2.20	3.69	3.78	3.02	5.14‡
Japan	+ 2.3	+ 0.5	Aug	0.34	0.02	0.61	1.65	1.35	1.87
Sweden	+ 0.5	+11.0	Jul	2.56	1.47	3.33	3.69	2.94	3.84
Switzerland	– 1.3	+ 0.8	Jul	1.71	0.76	2.02	2.43	1.80	2.53
United States	+ 0.2	+ 4.9	Jul	5.26	3.84	4.81	4.76	4.16	5.74
Euro area†	+ 7.4	+ 7.8	Jul	3.32	2.14	3.65	3.76	3.06	4.40

*Narrow: M1 except Britain notes and coin and Sweden M0, broad: M2 or M3 except Britain M4. †Germany for bonds. ‡New series. Benchmarks: US 30-year 4.89%, Japan No. 282 1.67%. Central bank rates: US fed funds 5.25%, ECB refinancing 3.00%, BOJ overnight call 0.25%, BOE repo 4.75%. Sources: Bank of Canada, Commerzbank, Danske Bank, Global Insight, JPMorgan Chase, Lehman Brothers, Stockholmsbörsen, UBS, Westpac, Thomson Datastream. Rates cannot be construed as banks' offers.

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The Economist commodity price index

Sep 14th 2006
From The Economist print edition

2000=100

	Sep 5th	Sep 12th*	% change on one month	% change on one year
Dollar index				
All items	174.6	170.4	– 1.4	+ 29.1
Food	135.2	132.7	– 1.3	+ 9.1
Industrials				
All	225.6	219.2	– 1.5	+ 50.7
Nfa†	142.7	138.9	– 7.9	+ 2.7
Metals	270.8	262.9	+ 0.5	+ 74.2
Sterling index				
All items	139.9	137.8	– 0.4	+ 25.4
Euro index				
All items	126.1	124.2	– 0.7	+ 24.9
Yen index				
All items	188.1	186.2	+ 0.1	+ 37.2
Gold				
$ per oz	637.50	593.70	– 4.5	+ 33.0
West Texas Intermediate				
$ per barrel	68.61	63.76	–12.7	+ 1.1

*Provisional. †Non-food agriculturals.

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Stockmarkets

Sep 14th 2006
From The Economist print edition

Market indices

	Sep 13th	2006 high	2006 low	% change on one week	% change on record high	% change on Dec 30th 2005 in local currency	% change on Dec 30th 2005 in $ terms
Australia (All Ordinaries)	4,978.6	5,318.2	4,708.8	– 2.0	– 6.4	+ 5.7	+ 8.4
Austria (ATX)	3,697.0	4,344.4	3,324.1	– 0.8	– 14.9	+ 0.8	+ 8.4
Belgium (Bel 20)	3,957.9	3,987.3	3,445.1	+ 1.9	– 0.7	+11.5	+19.9
Britain (FTSE 100)	5,892.2	6,132.7	5,506.8	– 0.6	– 15.0	+ 4.9	+14.5
Canada (Toronto Composite)	11,777.2	12,487.3	10,904.3	– 1.9	– 5.7	+ 4.5	+ 8.9
Denmark (OMXCB)	371.3	395.5	325.0	+ 0.5	– 6.1	+ 0.9	+ 8.5
France (SBF 250)	3,610.8	3,755.6	3,244.2	+ 0.3	– 17.8	+ 9.4	+17.6
France (CAC 40)	5,137.9	5,312.2	4,615.4	+ 0.4	– 25.8	+ 9.0	+17.1
Germany (DAX)*	5,906.1	6,140.7	5,292.1	+ 1.6	– 26.8	+ 9.2	+17.4
Italy (S&P/MIB)	37,981.0	38,765.0	34,850.0	+ 0.4	– 24.2	+ 6.4	+14.3
Japan (Nikkei 225)	15,750.1	17,563.4	14,218.6	– 3.3	– 59.5	– 2.2	– 1.9
Japan (Topix)	1,583.6	1,783.7	1,458.3	– 3.6	– 45.1	– 4.0	– 3.7
Netherlands (AEX)	471.1	478.0	412.9	+ 0.9	– 32.8	+ 7.9	+15.9
Spain (Madrid SE)	1,329.1	1,335.4	1,156.8	+ 0.8	– 0.5	+15.0	+23.5
Sweden (Affarsvarlden Gen)	319.9	333.7	275.2	+ 1.9	– 20.1	+ 9.0	+18.9
Switzerland (Swiss Market)	8,215.7	8,230.2	7,154.9	+ 0.5	– 2.3	+ 8.3	+14.0
United States (DJIA)	11,543.3	11,642.7	10,667.4	+ 1.2	– 1.5	+ 7.7	+ 7.7
United States (S&P 500)	1,318.1	1,325.8	1,223.7	+ 1.4	– 13.7	+ 5.6	+ 5.6
United States (NASDAQ Comp)	2,227.7	2,370.9	2,020.4	+ 2.8	– 55.9	+ 1.0	+ 1.0
Europe (FTSEurofirst 300)†	1,370.0	1,405.6	1,238.7	+ 0.4	– 19.6	+ 7.4	+15.4
Euro area (FTSE Euro 100)†	1,171.0	1,198.7	1,050.0	+ 0.8	– 24.5	+ 7.5	+15.6
World (MSCI)‡	1,353.5	1,406.3	1,243.9	– 0.2	– 6.6	+ 7.6	+ 7.6
World bond market (Citigroup)††	644.3	652.0	612.1	– 0.4	– 3.4	+ 3.9	+ 3.9

*Total return index. †In euro terms. ‡Morgan Stanley Capital International index includes individual markets listed above plus eight others, in $ terms. ††Citigroup World Government Bond Index, total return, in $ terms.

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Trade, exchange rates and budgets

Sep 14th 2006
From The Economist print edition

	Trade balance*, $bn latest 12 months	Current-account balance $bn latest 12 mths	Current-account balance The Economist poll % of GDP, forecast 2006	Current-account balance The Economist poll % of GDP, forecast 2007	Exchange rate trade-weighted† 2000=100 Sep 13th	Exchange rate trade-weighted† 2000=100 year ago	Currency units per $ Sep 13th	Currency units per $ year ago	Currency units per £	Currency units per euro	Currency units per ¥100	Budget balance % of GDP 2006‡
Australia	− 11.4 Jul	− 41.0 Q2	− 5.7	− 5.3	117.4	118.3	1.33	1.29	2.49	1.69	1.13	+ 0.9
Austria	− 1.3 Jun	+ 6.4 Q1	+ 0.5	+ 0.4	105.7§	104.8	0.79	0.81	1.48	–	0.67	− 1.9
Belgium	+ 14.9 Jun	+ 7.3 Mar	+ 1.5	+ 1.6	107.6§	106.5	0.79	0.81	1.48	–	0.67	− 0.4
Britain	−140.1 Jul	− 52.3 Q1	− 2.7	− 2.7	101.7	100.6	0.53	0.55	–	0.68	0.45	− 3.4
Canada	+ 58.8 Jul	+ 28.6 Q2	+ 2.3	+ 1.5	128.7	122.1	1.12	1.18	2.10	1.42	0.95	+ 2.2
Denmark	+ 8.2 Jul	+ 5.9 Jul	+ 2.0	+ 1.8	106.6	105.6	5.88	6.06	11.0	7.46	5.00	+ 3.3
France	− 33.2 Jul	− 33.4 Jun	− 1.7	− 1.4	108.4§	107.1	0.79	0.81	1.48	–	0.67	− 2.9
Germany	+185.8 Jul	+106.2 Jul	+ 3.6	+ 3.6	110.1§	108.5	0.79	0.81	1.48	–	0.67	− 3.1
Italy	− 21.4 Jun	− 34.7 Jun	− 1.7	− 1.5	108.0§	106.8	0.79	0.81	1.48	–	0.67	− 4.2
Japan	+ 78.0 Jul	+165.1 Jul	+ 3.6	+ 3.5	79.8	86.3	118	110	221	149	–	− 5.2
Netherlands	+ 39.0 Jul	+ 46.2 Q2	+ 6.0	+ 5.9	108.5§	107.2	0.79	0.81	1.48	–	0.67	− 0.5
Spain	−103.2 Jun	− 91.6 May	− 8.0	− 7.7	105.9§	105.1	0.79	0.81	1.48	–	0.67	+ 1.1
Sweden	+ 19.4 Jul	+ 24.1 Q2	+ 6.7	+ 6.0	98.3	96.1	7.30	7.58	13.7	9.25	6.20	+ 1.7
Switzerland	+ 7.7 Jul	+ 51.7 Q1	+12.7	+12.1	105.0	106.8	1.25	1.26	2.35	1.59	1.06	− 0.2
United States	−839.7 Jul	−808.5 Q1	− 6.7	− 6.7	84.0	84.4	–	–	1.87	1.27	0.85	− 3.6
Euro area	− 13.5 Jun	− 52.1 Jun	− 0.4	− 0.2	118.7	115.5	0.79	0.81	1.48	–	0.67	− 2.3
MORE COUNTRIES	Data for the countries below are not provided in printed editions of *The Economist*											
Finland	+ 11.0 Jun	+ 11.0 Jun	na	na	109.2§	108.0	0.79	0.81	1.48	–	0.67	+ 2.2
Greece	− 39.2 Jun	− 25.0 Jun	na	na	105.0§	104.1	0.79	0.81	1.48	–	0.67	− 3.0
Iceland	− 2.0 Jul	− 3.1 Q1	na	na	85.6**	100.9	70.6	62.0	132	89.5	60.0	+ 2.0
Ireland	+ 38.1 Jun	− 5.6 Q1	na	na	113.9§	111.9	0.79	0.81	1.48	–	0.67	− 0.3
Luxembourg	− 5.1 Jun	+ 3.9 Q1	na	na	107.6§	106.5	0.79	0.81	1.48	–	0.67	− 1.7
New Zealand	− 4.6 Jul	− 10.1 Q1	na	na	127.4	137.8	1.54	1.41	2.89	1.95	1.31	+ 4.6
Norway	+ 59.0 Jul	+ 56.5 Q2	na	na	104.8	111.7	6.61	6.34	12.4	8.38	5.62	+ 18.5
Portugal	− 22.2 Jun	− 16.6 Jun	na	na	105.9**	105.0	0.79	0.81	1.48	–	0.67	− 5.0

*Merchandise. Australia, Britain, France, Canada, Japan and United States imports fob, exports fob. All others cif/fob. †Bank of England except §IMF, July average. ‡OECD forecast. **IMF, June average.

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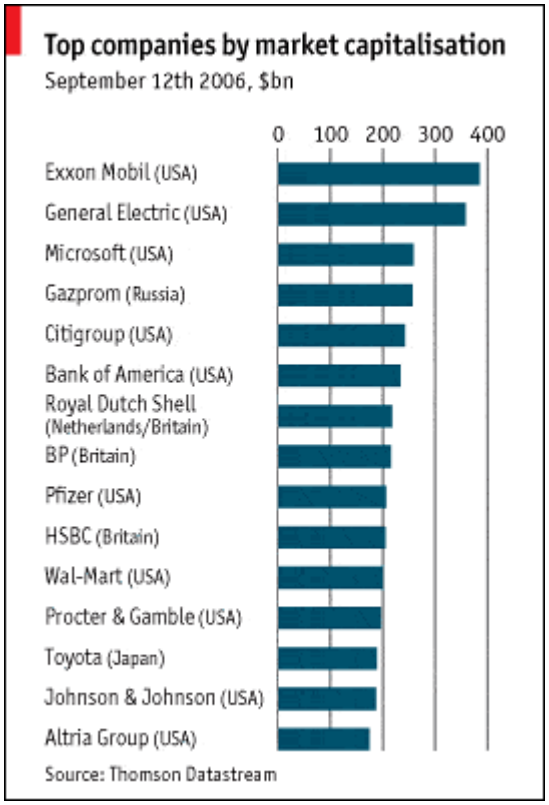
Top companies by market capitalisation

Sep 14th 2006
From The Economist print edition



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Overview

Sep 14th 2006
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China chalked up a record trade surplus of $18.8 billion in August and its industrial production was 15.7% greater than in the same month a year before.

Russia's GDP grew by 7.4% in the year to the second quarter, faster than the 5.5% it managed in the year to the first; **India's** industrial production expanded by 12.4% in the year to July, its quickest pace in a decade.

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FDI

Sep 14th 2006
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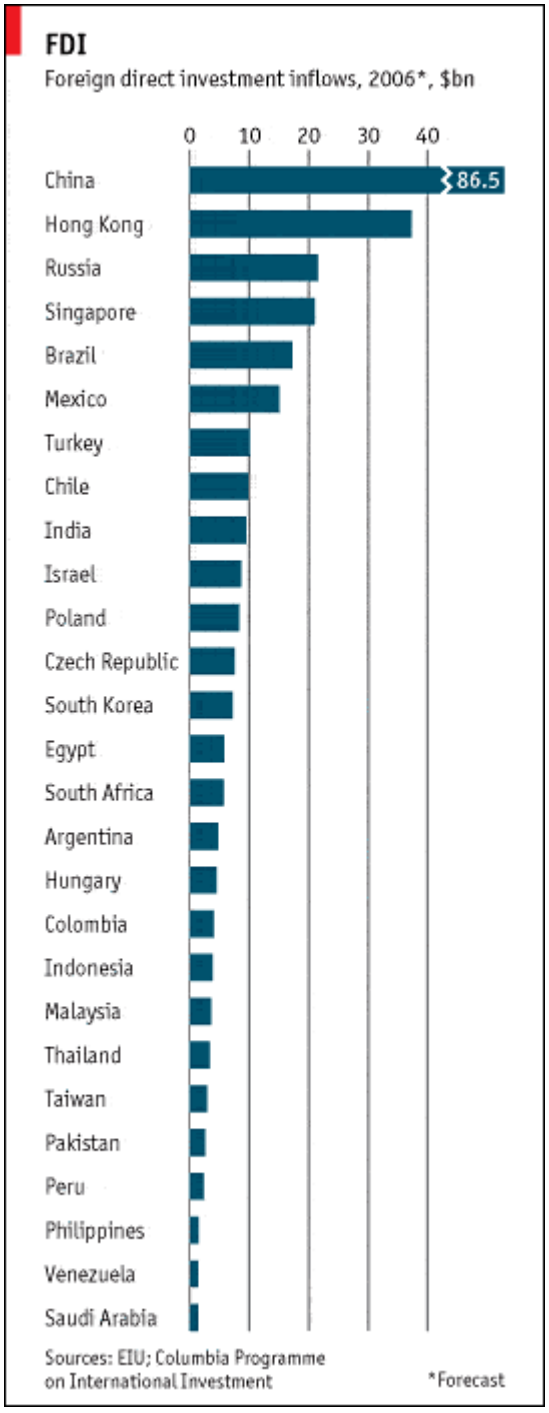
Inflows of foreign direct investment (FDI) will grow by 22% to reach $1.2 trillion in 2006, according to "World Investment Prospects to 2010" published by the Economist Intelligence Unit, a sister organisation, and the Columbia Programme on International Investment. The report predicts that America will be the most powerful FDI magnet this decade, whereas emerging markets will be disappointing.



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Economy

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	% change on year ago						Latest 12 months, $bn				Foreign reserves* $bn, latest	
	GDP		Industrial production		Consumer prices		Trade balance		Current account			
China	+11.3	Q2	+15.7	Aug	+ 1.3	Aug	+135.9	Aug	+160.8	2005	941.1	Jun
Hong Kong	+ 5.2	Q2	+ 7.0	Q1	+ 2.3	Jul	−14.2	Jul	+20.8	Q1	128.9	Aug
India	+ 9.3	Q1	+12.4	Jul	+ 6.7	Jul	−41.3	Jul	−10.6	Q1	158.0	Aug
Indonesia	+ 5.2	Q2	+ 1.0	Jun	+14.9	Aug	+34.7	Jul	+ 3.8	Q1	38.5	Jun
Malaysia	+ 5.9	Q2	+ 7.3	Jul	+ 4.1	Jul	+28.0	Jul	+19.5	Q1	78.8	Jul
Pakistan	+ 6.6	2006†	+14.3	Jun§	+ 7.6	Jul	−12.5	Jul	− 5.0	Q2	11.6	Jun
Philippines	+ 5.5	Q2	− 4.3	Jun	+ 6.3	Aug	− 3.8	Jun	+ 2.9	Mar	18.6	Aug
Singapore	+ 8.1	Q2	+19.6	Jul	+ 1.1	Jul	+33.0	Jul	+38.3	Q2	130.7	Aug
South Korea	+ 5.3	Q2	+ 4.4	Jul	+ 2.9	Aug	+16.0	Aug	+ 6.0	Jul	227.0	Aug
Taiwan	+ 4.6	Q2	+ 7.9	Jul	− 0.6	Aug	+19.4	Aug	+20.6	Q2	261.0	Aug
Thailand	+ 4.9	Q2	+ 6.1	Jul	+ 3.8	Aug	− 2.3	Jul	+ 2.8	Jul	57.1	Jul
Argentina	+ 8.6	Q1	+ 8.8	Jul	+10.7	Aug	+11.5	Jul	+ 6.7	Q1	25.1	Jul
Brazil	+ 1.2	Q2	+ 3.2	Jul	+ 3.8	Aug	+46.1	Aug	+12.5	Jul	66.1	Jul
Chile	+ 4.5	Q2	+ 1.9	Jul	+ 3.8	Aug	+18.5	Aug	+ 2.2	Q2	16.3	Aug
Colombia	+ 3.7	Q2	+10.0	Jun	+ 4.7	Aug	+ 0.8	Jun	− 2.0	Q1	14.9	Aug
Mexico	+ 4.7	Q2	+ 5.8	Jul	+ 3.5	Aug	− 4.1	Jul	− 0.6	Q2	83.0	Jul
Peru	+ 6.9	Jun	+11.7	Jun	+ 1.9	Aug	+ 6.9	Jul	+ 1.3	Q2	13.5	Jul
Venezuela	+ 9.2	Q2	+13.7	May	+14.9	Aug	+37.2	Q2	+29.5	Q2	23.8	Jun
Egypt	+ 5.9	Q1	+ 4.0	2005†	+ 8.4	Jul	−11.2	Q1	+ 2.1	Q1	23.2	Aug
Israel	+ 6.2	Q2	+12.3	Jun	+ 2.4	Jul	− 7.9	Aug	+ 5.8	Q2	28.1	Aug
Saudi Arabia	+ 6.6	2005‡	na		+ 2.1	Jun	+126.5	2005	+90.7	2005	22.8	Jul
South Africa	+ 3.6	Q2	+ 5.8	Jul	+ 5.0	Jul	− 7.9	Jul	−11.7	Q1	21.9	Aug
Czech Republic	+ 6.2	Q2	+11.8	Jul	+ 3.1	Aug	+ 1.6	Jul	− 3.8	Q2	30.7	Aug
Hungary	+ 3.8	Q2	+12.2	Jul	+ 3.5	Aug	− 3.3	Jul	− 7.9	Q1	20.8	Aug
Poland	+ 5.5	Q2	+14.3	Jul	+ 1.1	Jul	− 3.2	Jul	− 4.9	Jul	16.3	Jul
Russia	+ 7.4	Q2	+ 2.9	Jul	+ 9.7	Aug	+139.6	Jul	+91.4	Q2	252.2	Aug
Turkey	+ 7.5	Q2	+ 9.5	Jul	+10.3	Aug	−50.1	Jul	−29.6	Jul	57.0	Jul
MORE COUNTRIES	Data for the countries below are not provided in printed editions of *The Economist*											
Estonia	+12.0	Q2	+ 7.6	Jul	+ 5.0	Aug	− 2.7	Jun	− 1.8	Jun	2.1	Jun
Latvia	+10.9	Q2	+ 3.9	Jul	+ 6.8	Aug	− 3.6	Jun	− 2.6	Jun	3.2	Jun
Lithuania	+ 7.7	Q2	na		+ 4.2	Aug	− 4.2	Jul	− 2.2	Jun	4.1	Jun
Slovakia	+ 6.2	Q2	+ 8.3	Jul	+ 5.1	Aug	− 2.9	Jun	− 4.6	May	15.5	Jun
Slovenia	+ 4.9	Q2	+ 7.1	Jul	+ 3.2	Aug	− 1.8	Jul	− 0.3	Jun	8.6	May

*Excluding gold, except Singapore and China; IMF definition. †Year ending June. ‡Economist Intelligence Unit estimate. §New series.

Sources: National statistics offices, central banks and stock exchanges; Thomson Datastream; Reuters; WM/Reuters; Hong Kong Monetary Authority; Centre for Monitoring Indian Economy; Bank Leumi le-Israel; Standard Bank Group

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Financial markets

Sep 14th 2006
From The Economist print edition

	Currency units			Interest rates	Stockmarkets	% change on		
	per $		per £	short-term	Sep 13th		Dec 30th 2005	
	Sep 13th	year ago	Sep 13th	% a year		one week	in local currency	in $ terms
China	7.95	8.09	14.9	2.90	1,776.9	+1.1	+ 45.5	+ 47.8
Hong Kong	7.78	7.76	14.6	4.21	17,210.0	-0.3	+ 15.7	+ 15.3
India	46.2	43.8	86.6	6.42	11,893.8	-0.3	+ 26.6	+ 23.3
Indonesia	9,113	10,000	17,084	11.68	1,451.1	- 1.5	+ 24.8	+ 34.8
Malaysia	3.67	3.77	6.89	3.85	954.3	-0.2	+ 6.1	+ 9.1
Pakistan	60.5	59.8	113	9.96	9,990.1	-0.8	+ 4.5	+ 3.3
Philippines	50.4	55.9	94.4	7.25	2,379.4	-0.7	+ 13.5	+ 19.6
Singapore	1.58	1.68	2.96	3.44	2,508.0	-0.7	+ 6.8	+ 12.7
South Korea	959	1,026	1,798	4.67	1,333.1	- 1.8	- 3.4	+ 1.9
Taiwan	32.9	32.8	61.7	1.79	6,664.9	- 0.4	+ 1.8	+ 1.5
Thailand	37.4	40.9	70.0	5.35	698.2	- 0.5	- 2.2	+ 7.4
Argentina	3.11	2.92	5.82	10.19	1,648.8	- 0.4	+ 6.8	+ 4.1
Brazil	2.17	2.33	4.07	14.17	35,512.0	- 3.3	+ 6.1	+ 14.1
Chile	538	536	1,008	5.04	10,057.8	- 2.5	+ 9.3	+ 4.0
Colombia	2,406	2,290	4,510	6.50	9,556.8	+ 5.6	+ 0.5	- 4.5
Mexico	11.0	10.9	20.7	7.08	20,742.4	- 1.1	+ 16.5	+ 12.4
Peru	3.25	3.29	6.10	4.50	9,872.5	- 5.2	+105.6	+116.8
Venezuela	2,696§	2,651§	5,054	10.01	35,076.1	- 0.1	+ 72.0	+ 65.0
Egypt	5.74	5.77	10.76	9.07	53,776.6	+0.8	- 2.9	- 2.9
Israel	4.38	4.52	8.21	5.61	819.5	+2.2	- 1.0	+ 4.1
Saudi Arabia	3.75	3.75	7.03	5.24	11,240.5	- 1.9	- 32.7	- 32.7
South Africa	7.35	6.35	13.8	8.15	21,328.4	-4.7	+ 17.9	+ 1.7
Czech Republic	22.5	23.8	42.2	2.48	1,463.7	+0.3	- 0.6	+ 8.8
Hungary	216	199	404	7.71	22,820.9	+0.4	+ 9.8	+ 9.0
Poland	3.12	3.18	5.85	4.21	44,795.8	+0.2	+ 25.8	+ 31.3
Russia	26.8	28.3	50.3	11.50	1,556.3‡	-4.5	+ 29.0	+ 38.3
Turkey	1.47	1.34	2.76	19.65	37,774.6	+0.2	- 5.0	- 12.8
EM (MSCI)*	1.00	1.00	1.87	na	770.0	- 1.4	+ 9.0	+ 9.0
EMBI+†	1.00	1.00	1.87	na	386.9	-0.7	+ 5.0	+ 5.0

*Emerging Mkts. †JPMorgan Chase's Emerging Mkts Bond Index Plus. ‡In $ terms. §Trading market value.

Sources: National statistics offices, central banks and stock exchanges; Thomson Datastream; Reuters; WM/Reuters; Hong Kong Monetary Authority; Centre for Monitoring Indian Economy; Bank Leumi le-Israel; Standard Bank Group

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